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ABSTRACT

Described are four different corporate initiatives that help employees pay for work-related child care expenses: vouchers, discounts, flexible benefit programs and comprehensive cafeteria plans, and flexible spending accounts with salary reduction. Several other options, such as corporate contributions to community programs, subsidizing on-site centers, Voluntary Employee Beneficiary Asssociations, and lobbying are mentioned briefly. Focusing primarily on the experiences of larger corporations, the information in this report is based on a survey of employers known to provide child care vouchers and discounts or to include child care in their flexible benefit plans. A total of 113 surveys were distributed; 38 companies responded with usable information. An additional 20 company programs are described, based on information provided at conferences and in the literature. Appended to the report are a sample dependent care assistance plan and guidelines for selecting a tax treatment plan for dependent care, including a comparison between salary reduction and the dependent care credit. (RH)

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The Conference Board
Research
Bulletin

No. 177

Corporate Financial Assistance for Child Care

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By Dana Friedman

Management Summary

Financing—The Most Popular Child Care Option 3
Among an estimated 1800 employers providing child care assistance, the majority of companies help their employees pay for child care.

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WORK AND FAMILY INFORMATION CENTER

Terms Used in This Report

This is an area in which some everyday words have developed specialized meaning.

Child Care, Day Care: Care of infants, preschoolers or school-age children by someone other than parents. Children's advocates prefer the term "child care" to avoid confusion with "adult day care" and to change the field's image from what used to be thought of as a custodial, babysitting service for the poor.

Day-care Center: A facility that cares for more than six children: includes preschools, nursery schools, prekindergarten programs, and child-care centers. Most programs have an educational or developmental focus and must be licensed by the state. There are an estimated 20,000-30,000 full-day day-care centers in the United States as of early 1985. Not included in this number are half-day nursery schools and kindergarten programs in the public schools.

On-site Day-care Center: A child-care facility operated on or near company premises, which may be owned and operated by the company or contracted out to a profit or nonprofit agency to run for the employer. As of January, 1985, there were an estimated 120 on-site centers at companies, 400 at hospitals, and 50 sponsored by public agencies.

Family Day-care Home: The most common form of child care in which a neighbor, usually a woman, cares for up to six children in her own home. An estimated 5 million children are cared for in family day-care homes. Most states require homes to be licensed or registered, although an estimated 70 percent are not.

Dependent Care Assistance Plan (DCAP): A written plan required by Section 129 of the Internal Revenue Code as stipulated in the 1981 Economic Recovery Tax Act. The plan makes employer contributions to the care of children, elderly parents, and disabled dependents nontaxable to the employee and tax deductible to the employer.

Resource and Referral (R&R): Also known as "Information and Referral." A counseling service for parents to help them find available child care in the community. These agencies (usually nonprofit) keep computerized lists of services indicating their location, hours, fees and availability. They also help stimulate the supply of services where needed. An estimated 200 R&R agencies exist across the country. Some are designed to administer voucher programs for local employers.

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The Conference Board Research Bulletin

Corporate Financial Assistance for Child Care

Part 1
Introduction

Since 1980, there has been dramatic growth in the portion of the United States labor force that must purchase child-care services in order to work. Inflation increased the need for the two-paycheck family. Divorce contributed to the number of single parents serving as sole support of their families. Attitudinal changes—growth of the service economy, and equal-opportunity legislation among them—further increased the labor-force participation of mothers—most of whom are part of the baby-boom generation. These factors have created an unprecedented need for child care at a time when affordable, quality services are beyond the reach of many working parents.

Employers concerned about attracting and retaining a productive work force have begun to address the child-care needs of their employees. According to The Conference Board's Work and Family Information Center, approximately 1,800 employers currently provide some form of child-care assistance. The corporate response includes on-site day-care centers, after-school care programs, sick-child care, information and counseling services, and corporate contributions to community-based programs. However, the majority of employers provide some form of financial assistance for child care.

The popularity of a monetary response to child-care needs can be attributed to at least two factors. First, employers realize that affordability may be the most significant child-care problem facing working parents. Parents' inability to purchase reliable, quality child care may be the cause of absenteeism and poor work performance. The second reason for the growth of corporate financing of child care is found in the tax laws. With passage of the 1981 Economic Recovery Tax Act (ERTA), child care became a nontaxable benefit and a convenient option to include in flexible benefit plans and salary-reduction programs. These forms of flexible compensation proliferated after passage of the Revenue Act of 1978, and child care, as a benefit, grew along with them.

Types of Financial Assistance

The employer's goals determine the form of financial assistance the company will provide to help employees absorb child-care costs. Where the employer's primary concern is the effect of inadequate child care on employees, management might subsidize employees' child-care costs through a voucher or vendor-discount plan. For example, the Polaroid Corporation offers vouchers—worth up to 80 percent of the cost of care—to purchase child care in the community. Kinder-Care, a profit-making chain of day-care centers, has contracts with 75 corporations for a variety of services including a 20-percent discount at Kinder-Care centers. Participating centers reduce their fees by 10 percent and the companies contribute 10 percent of the weekly fees.

Other employers focus initially on the appropriateness and cost of their benefit plans. In their attempts to satisfy the new diversity in their work forces, while simultaneously controlling benefit costs, companies offer child care as one of a number of benefit choices in a flexible benefit, or "cafeteria," plan.[1] In a comprehensive cafeteria plan, employees can select from a menu of benefits those they need most in exchange for other, less-needed, benefits. The flexible spending account, or reimbursement account, is another form of flexible benefits that is usually funded through salary reduction. These programs allow an employee to spend pre-tax dollars on child care or other benefits. Because no employer contribution is required, this form of flexible benefits is the most popular form of financial assistance for child care.

This report describes four different corporate initiatives that help employees pay for work-related child-care expenses: vouchers, discounts, comprehensive cafeteria plans, and flexible spending accounts with salary reduction. Several other options, such as corporate contributions to community programs, subsidizing on-site centers, Voluntary Employee Beneficiary Associations (VEBA's), and lobbying are mentioned briefly. While the tax law permits employers to assist with the cost of care for elderly parents and disabled dependents, this report focuses only on the financing of care for infants, preschoolers and school-age children.

The practice of corporate financing for child care is very much a moving target. However, the structure of various model programs can be identified. The voucher programs offer opportunities for the most creativity and several models

[1] See Mitchell Meyer, *Flexible Employee Benefit Plans: Companies' Experiences*. The Conference Board, Report No. 831, 1983.

About This Report

The information in this report is based on a survey of employers known to provide child-care vouchers and discounts, or to include child care in their flexible benefit plans.

A total of 113 surveys were distributed, to which 38 companies responded with usable information. An additional 20 company programs are described, based on information provided at conferences and in the literature.

The first task in this study was to identify the employers with experience in providing one of the four selected financing mechanisms. The Work and Family Information Center of The Conference Board is in the process of developing a computerized data bank, which will eventually include all such company programs; however, no comprehensive list currently exists. Therefore, an informal network of child-care organizations and benefit-consulting firms were contacted in the Fall of 1983 to identify companies with various types of programs for financing child care. Additional examples were identified at conferences and through a literature search.

In order to identify employers with voucher plans, child-care consultants, information and referral agencies, and advocacy groups were contacted in 25 U.S. cities. To this list were added the names of employers providing vouchers identified by the National Employer Supported Child Care Project and by research sponsored by the American Management Association. This process provided a list of twenty-three companies with voucher plans. Six of these companies responded to The Conference Board's survey.

The discount program is typically offered by profit-making chains of day-care centers. Kinder-Care, the largest of these chains, shared its list of participating companies. Of the 75 companies offering Kinder-Care discounts, 11 responded to the survey. The remaining three companies offering discounts and responding to the survey were identified by the Children's World chain and Community Coordinated Child Care (4C) of Central Florida. Although several other chains would not release their lists of clients, their experience with company discounts is reflected in the report.

It was more difficult to obtain a list of companies with flexible benefit plans that include a dependent-care option. Leading benefit-consulting firms, the Employers Council on Flexible Compensation, and the Employee Benefits Research Institute were able to name the larger corporations with comprehensive cafeteria plans. Several programs in smaller-sized companies, hospitals, municipalities and nonprofit agencies were identified through local contacts in several U.S. cities. However, this report focuses primarily on the experiences of larger corporations. Of a group of 27 employers offering flexible plans, 15 responded to the survey; seven employers explained that their plans did not include dependent care.

are identified and described in this report. There is less variety in the structure of discounts and typical corporate experiences are covered. This study takes into account recent developments in the regulation of flexible benefits. The models presented in this report appear to be representative of the flexible programs currently in place.

History of Employer-Supported Child Care

During the Civil War, manufacturers of ammunition and soldiers' clothing established day nurseries so that women could help in the war effort. A similar need prompted hospitals and war-related industries to create day-care centers during World War I and, with government funds provided under the Lanham Act, nearly 2,500 day-care centers were established at plants during the Second World War.

After World War II, industry's interest in child care waned. Interest was restimulated in 1967, when Congress passed legislation allowing for the rapid tax amortization of capital expenses for on-site day-care centers. Gerber Foods, among others, opened day-care centers expecting to make a profit. Other companies, such as Stride Rite Shoes, KLH, and Polaroid Corporation, provided child-care assistance as a way to express corporate social responsibility. During the period between 1964 and 1972, approximately 18 corporate on-site day-care centers and 70 hospital-based centers for employees' children were opened. Fifteen of the corporate centers have closed; only Stride Rite, Photo Corporation of America, and Forney Engineering are still operating.[2]

More than a decade after the last flurry of interest in employer-supported child care, at least 1,800 employers provide child-care assistance. However, recent interest in child care is characterized by the alternatives to on-site day-care centers. Not only have companies learned from the lessons of earlier center closings, they have also recognized the inappropriateness of the on-site solution given management objectives, parent preferences, and children's special needs. Parents may not need a service at the workplace as much as they may need help in finding, selecting or paying for child care already available in the community. They may also need more conveniently arranged time to balance family and work responsibilities.

Reasons for Employer Involvement

Less than a quarter of U.S. families are composed of a male breadwinner nourishing his wife at home and 2.6 children.[3] As family structures change, so does the composition of the work force. In order for a business to attract and retain a productive work force, it has begun to consider the family needs of its workers. According to an analysis of census data by the Children's Defense Fund, (a national advocacy organization in Washington, D.C.), 80 percent of

[2] For historical information on employer-supported child care, see: Women's Bureau, U.S. Department of Labor. *Employers and Child Care: Establishing Services at the Workplace*. Washington, DC: U.S. Government Printing Office, 1982; Welfare Research, Inc. *On-Site Day Care: The State of the Art and Model Development*. Albany, NY: Welfare Research, Inc., 1980. (Available from Molly Hardy, Empire State Day Care Services, Inc., Agency Building #2, 12th Floor, Albany, NY 12223.

[3] Bureau of the Census, U.S. Department of Commerce. "Marital Status and Living Arrangements: March 1980." Current Population Reports, Series P-20, 1981.

women in the work force are of child-bearing age and an estimated 93 percent of these women workers will become pregnant some time during their work careers. Since two-thirds of the new entrants into the labor market by 1990 will be women, their needs are likely to play a role in the design of recruitment efforts, productivity incentives, and benefit plans. And because nearly 60 percent of married men in the work force have wives working full- or part-time, they, too, have family concerns that differ greatly from those of the male breadwinner for whom benefit plans and work schedules were originally designed.[4]

An increasing number of employers are concerned about producing goods and services in competitive world markets and recruiting workers in tight labor markets. Although there are pockets of unemployment in some older industrial firms, at the same time, there are labor shortages in some parts of the high-technology and service industries. Companies in Silicon Valley, California, the Research Triangle, North Carolina, and along Route 128 outside Boston have expressed more interest in family issues than have employers in Detroit, Akron or Toledo.[5]

Over 40 percent of the labor force—about 40 million workers—have children under the age of 18. (A growing number are also likely to have elderly parents or disabled dependents.) Child care is one of the most pervasive needs because family members are not available to care for young children during the day.

The fastest-growing segment of the work force consists of mothers of preschool children, 52 percent of whom were in the labor force in 1984. The increase in the proportion of mothers with children under three is even more dramatic: In 1975, 34 percent of this group worked; by 1984, the figure had increased to 48 percent. It is expected that, by 1990, 64 percent of all families with children will include working mothers with responsibility for approximately 10.4 million children under the age of six. Nearly 20 percent of these children will live in single-parent families.[6]

As families turn to the community for child care, they may be faced with a tiresome search for affordable, quality programs. The government has reduced some of its support for services to low-income parents. United Ways spend less than 5 percent of all their resources on child care. Parents' fees and contributions are the primary sources of revenues for the U.S. child-care system—a system that is often inadequate. Parents may use as many as four different arrangements each week, some of which may be of questionable quality. According to the Children's Foundation, (a nonprofit advocacy organization in Washington, D.C.), an estimated 5 million children are cared for in family day-care homes—nearly 70 percent of which are unlicensed or unregulated. An unknown number of children are left to care for themselves. In the aftermath of several incidents of sexual abuse in child-care programs (in both day-care centers and family day-care homes) there is increasing concern about the quality of child care in this country. Efforts to improve quality will probably lead to an increase in the cost of care.

The insufficient supply of services creates two sources of pressure on employers:

- Parents bring their unmet child-care problems to the workplace.
- Community-based services, struggling for their own survival, look to the business community as a new source of support.

Employees are now more likely to raise the subject of their concerns at the workplace—in part because of increased opportunities offered by the company through quality circles, employee attitude surveys, counseling services, parent education seminars, and focus groups. At the same time, business is hearing from a new breed of employee, the "new values worker."[7] These are people who are becoming increasingly concerned about the quality of their lives, and who are more willing to express those concerns. In addition, the baby-boom generation has come of managerial age, but sheer numbers will prevent all who desire success from achieving it. With employees caught in this so-called "pyramid squeeze," employers may need to devise new benefits and rewards.

The new diversity among workers also demands flexibility in corporate policies.[8] Three of the more popular management initiatives under consideration are flexitime, flexible benefits, and flexiplace (work at home or telecommuting). Child care thus becomes another response to the concerns of an increasingly large segment of the changing work force. Through their attention to child care, corporations expect to solve some of their employees' family problems while furthering management's concerns for a dependable work force.

The Cost of Child Care

Raising children is an expensive undertaking. It cost approximately $2,500 to give birth to a child in 1982, according to the Health Insurance Association of America, and $140,927

[4] See Helen Axel, *Corporations and Families: Changing Practices and Perspectives.* The Conference Board, Report No. 868, 1985; and, Children's Defense Fund. *Employed Parents and Their Children: A Data Book.* Washington, DC: Children's Defense Fund, 1982, p. 4.

[5] Motivations for corporate involvement in child care are more fully discussed in Dana E. Friedman, *Encouraging Employer Support to Working Parents,* Report for the Carnegie Corporation of New York, 1983. (Distributed by the Center for Public Advocacy Research, 12 West 37th Street, New York, NY 10018.) See also Renee Y. Magid, *Child Care Initiatives for Working Parents: Why Employers Get Involved.* New York: American Management Association, 1983.

[6] "Working Mothers Reach Record Numbers in 1984," *Monthly Labor Review,* December 1984, p. 31-34.

[7] Daniel Yankelovich, *New Rules: Searching for Self-Fulfillment in a World Turned Upside Down.* New York: Random House, 1981.

[8] See Harriet Gorlin, *Issues In Human Resources Management, 1985.* The Conference Board, Report No. 849, 1984.

to raise a child born in 1984 to age 18—nearly three times the cost of raising a child born in 1966.[9] A portion of that increase is explained by the growing need, or desire, to purchase child-care services. For working families, child care is the fourth largest budget item—exceeded only by food, housing and taxes. Child-care costs typically absorb 10 percent of a family's budget; for a family with two preschoolers, child care can amount to as much as 30 percent of a family's budget.[10]

The costs of child care vary according to the numbers and ages of children needing care, the type of care chosen, and the number of hours care is used. All of these factors are related to the income and education levels of the parents. One study suggests that 64 percent of all three- and four-year olds living in families with incomes greater than $20,000 are enrolled in some form of child care outside the child's home. Families with incomes below $20,000 are more likely to rely on relatives or family day-care arrangements, which are usually less expensive. Furthermore, 70 percent of parents with at least three years of college place their children in some part- or full-day child-care center. Informal arrangements, such as family day care, are used more often by parents with less education.[11] However, parents from all backgrounds seem to prefer family day care for their infants.

As evidenced by the data in Table 1, care for infants and toddlers (children under three years of age) tends to be more expensive than care for preschoolers (children aged three to five). Center-based care is typically more expensive than family day care, although care for an infant in family day care can be as expensive as—or more expensive than—care for a preschooler in a center. The least expensive programs are those serving school-age children (those six to thirteen). An in-home caregiver, unrelated to the child, is the most expensive form of child care: At $250 per week, child care would cost $13,000 per year, plus Social Security, unemployment and workers' compensation which increases the cost by 10 percent.

There are significant regional differences in the costs of care for children of various ages and for each type of care. For instance, it is most expensive to purchase child care in the Northeast, and cheapest in the South. As a result of these variations, out-of-home care for one child can cost anywhere from $1,500 to $10,000 per year, with the majority of parents paying $3,000 per year for child-care services.

Parents' Ability to Pay

According to *Forbes* magazine, the need for child care creates an estimated $10-billion a year service industry.[12] Parents pay approximately 70 percent of the costs of running these programs.[13] Like all goods and services, the cost of providing child care has risen. To ease the burden, most child-care programs offer reduced rates for enrolling more than one child. Sliding fee scales can help lower-income families afford program fees, but fewer than 10 percent of day-care centers vary their fees by income.[14]

In recognition of child care as a work-related expense, the Federal Government created a child-care tax credit in 1976 (See box, p. 8.) In 1982, over 5 million families received $1.5 billion in child-care credits (See Table 2). In 1983, child-care credits increased to $2.06 billion. As amended in 1982, a 30-percent credit may be taken by families with adjusted gross incomes of $10,000 or less. The credit is reduced by 1 percent for each $2,000 increase in income, and is limited to a 20-percent credit for those with incomes of $30,000 or more. The credit ranges from $480 to $720 for one child and from $960 to $1,440 for two or more children.

The credit may not be claimed against expenses in excess of $2,400 for one child and $4,800 for two or more. As indicated earlier, average costs exceed these amounts. In addition, the credit cannot be greater than the filer's tax liability.[15] As a result, many low-income families cannot take advantage of the credit. Only 15 percent of families using the credit in 1982 had incomes below $12,000. The Children's Defense Fund estimates that between a quarter and a third of eligible families applied for the Dependent Care Tax Credit.

Legislators, parents and child-care advocates have focused attention on the role of employers in making child care more affordable. One strategy for accomplishing this was embodied in Section 129 of the 1981 Economic Recovery Tax Act (ERTA), which authorized the creation of Dependent Care Assistance Plans (DCAP's). This provision made child care a nontaxable benefit for the employee and a tax-deductible contribution for the employer. Legislators anticipated that this provision would motivate employers to create voucher plans, through which employers' dollars are contributed to their employees' child-care costs, accord-

[9] Health Insurance Association of America, *Cost of Having A Baby*. Washington, DC: Health Insurance Association of America, (1850 K Street, NW, Washington, DC 20006), 1984.

[10] W. Gary Winget, "The Dilemma of Affordable Child Care," in Edward F. Zigler and Edmund W. Gordon, eds., *Day Care: Scientific and Social Policy Issues*. Boston: Auburn House, 1982, p. 357.

[11] Sheila Kamerman, "Child Care Services: A National Picture," *Monthly Labor Review*. December 1983.

[12] John A. Byrne and Paul B. Brown, "Those Unpredictable Babies." *Forbes*, November 22, 1982.

[13] Winget, 1982.

[14] Roger Neugebauer, "Implementing a Sliding Fee Scale System for your Center," *Child Care Information Exchange*, Redmond, Washington, June 1984.

[15] Legislation to make the credit refundable may be introduced in the current Congress. The Senate supported refundability in 1976 and 1981, but the House opposed the measures because of concerns about revenue loss and questions about how helpful refundability would be to low income parents. In 1983, President Reagan proposed an expansion limiting eligibility to families earning less than $60,000. Several tax-reform proposals would eliminate the child-care credit entirely.

Table 1: Comparative Weekly Costs for Child Care in Seven Major Cities, as of January, 1985.[1]

City[2]	Family Day Care Age[3]	Family Day Care Price[4]	Day-care Center Age[3]	Day-care Center Price[4]	School Age Program	Caregiver in Child's Home
Boston	Under 2	$45-160	Under 2	$90-150	$30-40	$260-340
	2-5	40-160	2-5	75-110		
New York	Under 2	35-140	Under 2	60-150	20-60	165-300[5]
	2-5	35-140	2-5	50-120		
Atlanta	Under 2	30-60	Under 2	35-70	20-35	165-230
	2-5	30-55	2-5	30-70		
St. Louis	Under 2	45-50	Under 2	65-80	10-32	165 and up
	2-5	35-40	2-5	50-70		
Dallas	Under 2	50-70	Under 2	60-90	25-35	165-200
	2-5	50-70	2-5	50-70		
Denver	Under 2	65-105	Under 2	65-105	30	165-200
	2-5	55-105	2-5	55-105		
San Francisco	Under 2	55-90	Under 2	90-120	1/hr	165-200
	2-5	55-85	2-5	65-90		

[1] Source: Cost estimates were provided by staff of the following information and referral agencies: Child Care Resource Center (Boston); Child Care, Inc. (New York); Child Care Solutions (Atlanta); Child Day Care Association of St. Louis; Child Care Dallas; Mile High United Way Child Care Information and Referral (Denver); and the Child Care Switchboard (San Francisco).

[2] Costs will vary throughout the city; suburban child care may be more expensive and was not included in these estimates.

[3] For some programs, the fees increase after age 3. This table reflects the general cost difference between care for infants and preschoolers. Toddler care (age 2-3) is likely to be less expensive than infant care and more expensive than preschool care.

[4] Costs refer to full-day child care.

[5] The $165 weekly rate is the minimum wage ($3.35/hour). Some respondents acknowledged that this care might be purchased for as little as $2.00/hour or as high as $8.50/hour.

Table 2: Use of the Dependent Care Tax Credit, 1982

Adjusted Gross Income	Number of Returns Claiming Credit	Percent of Total Returns Claiming Credit	Amount of Credit Received ($ thousands)	Percent of Credit Total Received By Income Group	Average Credit Amount Per Family
Less than $5,000	10,702	.21	$ 963	.06	$ 89.98
5,000–9,999	280,328	5.60	73,676	4.91	262.82
10,000–14,999	581,065	11.61	210,194	14.00	361.74
15,000–19,999	642,705	12.84	203,165	13.53	316.11
20,000–24,999	772,760	15.44	221,213	14.73	286.26
25,000–29,999	649,448	12.98	176,069	11.73	271.11
30,000–39,999	1,124,671	22.48	320,477	21.34	284.95
40,000–49,999	604,349	12.08	184,486	12.29	305.26
50,000–74,999	274,891	5.49	88,324	5.88	321.31
75,000–99,999	37,068	.74	12,142	.81	327.56
100,000–199,999	21,923	.44	8,832	.59	402.86
200,000–499,999	3,351	.07	1,702	.11	507.91
500,000–999,999	269	.005	145	.01	539.03
Over 1,000,000	109	.002	65	.004	596.33
Total	5,003,639		1,501,453*		

Source: Prepared by Nancy Duff Campbell, Attorney, National Women's Law Center, Washington, D.C. from data provided by the Internal Revenue Service.

* Child-care credits claimed on 1983 returns rose 37% from this 1982 level to $2.06 billion.

Dependent-Care Tax Credit

The dependent-care credit is a way to deduct a portion of child-care expenses from federal income taxes. If the credit exceeds tax liability, it can not be refunded. The tabulation below presents the credit limits currently applied to various income levels.

Adjusted Gross Income	*Percentage of Child Care Expenses to be Credited*	*Maximum Credits*	
		One Child	*Two or more Children*
Up to $10,000	30%	$720	$1,440
$10,001–12,000	29	696	1,392
12,001–14,000	28	672	1,344
14,001–16,000	27	648	1,296
16,001–18,000	26	624	1,248
18,001–20,000	25	600	1,200
20,001–22,000	24	576	1,152
22,001–24,000	23	552	1,104
24,001–26,000	22	528	1,056
26,001–28,000	21	504	1,008
28,001 and over	20	480	960

Who Is Eligible?

- A parent who is employed (either full- or part-time) or is actively seeking employment, or is a full-time student at least five months of the year,
- Two-parent families, where both parents are gainfully employed,
- Parents with one or more children under 15 who are claimed as dependents,
- Parents who pay over half the cost of keeping up their home,
- A parent who is divorced or legally separated, even though he or she does not claim the child as a dependent. Children must be under age 15. The parent must have custody for more than half the year and pay for over half of his or her support during the year. Only one parent may take a child-care credit for the care of any child.

Expenses Covered

All child-care expenses that are necessary for enabling a parent to work, with these exceptions:

- Expenses are limited to $2,400 if there is one child under 15 and $4,800 if there are two or more children under 15.
- Expenses that are paid by another party, whether through a scholarship, a government allowance, or employer subsidy.
- Transportation costs between home and the child care arrangement.
- Expenses claimed may not exceed the annual earned income of a single parent or the annual earned income of the spouse with the lower income in a married couple.
- Selected child-care programs must comply with state and local licensing laws.

Payments to relatives qualify if they are providing care as employees of another organization, or as self-employed persons in their homes, or as the parents' employees for whom Social Security taxes are withheld. However, payments to relatives who are claimed as dependents for the tax year do not qualify.

How the Credit Is Claimed

The credit may be claimed on either the short form (1040A) or the long form (1040) of the income-tax report with Form 2441, "Credit for Child and Dependent Care Expenses" attached. Parents making claims must have receipts for child care fees. The credit may be spread over the year by having less tax withheld from pay.

ing to legislative staff members who were interviewed. However, as a nontaxable benefit, child care became a convenient addition to flexible benefit plans. Many of these plans involve a program of salary reduction but no employer contribution. Rather, in this type of plan, employees reduce their taxable income and use pre-tax dollars to pay for their dependents' care.

Parents still directly absorb the majority of child-care costs. Cost is thus a critical factor in the selection of a child-care arrangement. According to a national consumer survey in 1975, parents "purport to select care for child-oriented reasons over cost or convenience."[16] To the degree that consumers consider the quality and appropriateness of a child-care setting, many may find that they are unable to afford their preferred form of child care.

[16] Office of Child Development, U.S. Department of Health, Education and Welfare. *National Child Care Consumer Study, Volume III: American Consumer Attitudes and Preferences on Child Care.* Washington, DC, 1985, pp. 4-21.

The Inability to Pay

There is little research on the effects of poor quality child care or the inability of parents to select their preferred form of child care. Yet, the scope and nature of these problems are emerging from child-care needs assessments conducted by employers. Further understanding comes from the anecdotes shared in parent-education seminars and counseling sessions at the workplace; from magazine and newspaper articles; and from testimony presented at congressional hearings.

For instance, when the affordable child-care choices are inconveniently located, parents may be forced to lengthen their morning commutes and run the risk of being late for work. Or, parents may need to leave work early in order to pick up children before centers close. On the other hand, the care might be convenient for the parent, but the child is unhappy, causing the parent to worry. If the situation warrants changing the child-care arrangement, the parent may require time off from work to visit other programs. In addition, the experience of experts in the field indicates that less expensive options may be of questionable quality.

When 60 to 80 percent of costs in a day-care center are designated for staff, cheaper care may have poor quality staff and high turnover. This frequently creates problems for the child and, ultimately, for the parent. Family day-care homes present a specific staffing problem: The parent may have to miss work if the provider is sick and has no back-up.

Some employers have felt the effects of problems associated with inappropriate child care. For this reason, a growing number of companies have begun experimenting with a variety of mechanisms that help ease the financial strain on the parents in order to facilitate their selection of more stable and better quality child-care arrangements.

Part 2

The Range of Financing Solutions

A significant amount of diversity and creativity characterizes the various child-care financing options. The program selected by an employer depends on three basic factors: (1) the level of financial commitment by the employer; (2) the special needs of parents in the work force; and, (3) the supply of child care in the community.

The options for corporate financial assistance for child care included in the survey and analyzed in this report include voucher programs, discount programs, and two types of flexible benefit plans. Other, less popular options are more briefly mentioned.

The financing options discussed below vary considerably in their cost to the employer and in their value to the employee. Only the discount program, which relies on a specific child-care vendor, limits the employee's choice. With most vouchers and all flexible benefit plans, employees are free to make their own arrangements, but satisfaction will depend on the availability of services in the community. In order for the value of financial assistance to be realized, employers sometimes provide additional funds to community programs to correct inadequacies in the child-care market.

Table 3 shows the prevalence of the various forms of financing options, the average amount of financial assistance gained by the employee, and the estimated expense per employee, to the company.

Trends in Employer Financing

Despite the variety of financing options and the uniqueness of each option once implemented, some patterns can be discerned among the group of employers providing financial assistance. Trends were observed in the types of employers involved, the extent of employee eligibility and utilization, and expected outcomes.

Child care—whether in the form of an on-site center or financial assistance—is concentrated in such high-growth industries as high technology and in the service sector, most notably banks, insurance companies, and hospitals.

Many of the larger corporations, able to afford the costs of studying and administering new benefits, have been in the forefront of the employer-supported child-care movement. The financing option is particularly attractive to large, multisite corporations because they can provide assistance in several locations. They are less likely to build numerous day-care centers to meet the needs of employees across the country. Small firms have been less involved in child-care provision until the advent of child care as a nontaxable benefit and the development of flexible spending accounts.

In most of these companies more than 50 percent of the employees are women. Yet, "female intensiveness" is not a prerequisite for involvement in child care. Procter & Gamble, for instance, has a 30-percent female work force, and American Can has only 25 percent. Measurex Corporation, which offers a voucher specifically designed to get women back to work after maternity leave, has a 37-percent female work force.

Only five of the thirty-eight companies responding were unionized. Unions have not been particularly active in child care, possibly because they do not have a presence among the fastest growing segments of the labor force: technical, white-collar, and women workers.

Eligibility

Companies almost always provide financial assistance on a companywide basis. Several firms had pilot tested their programs at their headquarters and then expanded them to other sites. The companies pioneering cafeteria benefit plans typically started the plan in one division to test reactions and fine-tune the administrative mechanism. In the few unionized companies in this sample, child-care assistance was not extended to union members. Approximately half of the responding companies offered the child-care benefit to part-time workers, prorating the value of the benefit according to the number of hours worked.

Utilization

Most companies found that less than 10 percent of the employee population took advantage of the financial assistance offered to cover child-care expenses. A variety of explanations may account for these low utilization rates. (No company had knowledge of the percent of *eligible* employees utilizing dependent care assistance. Several estimated that use by parent-employees was about 25 percent.)

Less than 40 percent of a typical employee population are

Table 3: An Overview of Various Financial Assistance Programs for Child Care

	Vouchers	*Discounts*	*Cafeteria Plans*	*FSA/SR*[1]
Estimated number of companies	25	300	75	500
Average amount of financial assistance to employee per year	$1,000	$500	$5,000	$5,000
Yearly cost per employee to the employer	$1,000	$500	$ 300	0[2]

These data were compiled from the surveys and estimates offered by consulting firms and child-care organizations.

[1] FSA/SR = Flexible Spending Account/Salary Reduction.

[2] The flexible spending account may involve an employer expense.

likely to have children. Some of these employees are part of dual-earning couples; others are single parents. Approximately 20 percent of these working families have children under the age of six. Furthermore, over 50 percent of parents with preschool children arrange for care by relatives.[1] If a personal deduction is claimed for these relatives, the number of working parents who have reimbursable child-care expenses may be further reduced. Given the marital status of employees, ages of children, and child-care arrangements selected, any work force may have fewer than 5 percent able to apply for dependent-care assistance.

There will be turnover among the employees requiring child-care assistance. As the need for child care ceases for some parents, because their children are older, other employees will bear children and need child care for the first time. While utilization may remain at 5 percent each year, the company is actually serving a larger proportion of the employee population over time.

The type of child care used by families may further inhibit their participation in a child-care assistance program. Certainly, in a discount program, only those employees approving of the specific vendor chosen will apply. All other financing options allow employees to choose their own arrangements. If parents choose an arrangement that does not meet the criteria for dependent-care tax credits (page 8), their child-care costs may be taxable and they may not participate in their employer's plan. Limited use of dependent care might occur in a flexible benefits plan if the parent must choose between dependent care and needed health care benefits. The forfeiture provision in the proposed IRS regulations may further reduce the selection of dependent care in a cafeteria plan. Forfeiture occurs when employees do not spend all of the funds in their accounts by the end of the year. A decline in utilization after complying with the proposed regulation was reported by three companies participating in this survey. Most of the employees interviewed felt that, despite low utilization, child-care users benefited greatly from the financial assistance offered.

Substantiating Claims

When employers help pay for the child care selected by the parent, they often require receipts from the provider before expenses will be reimbursed. Companies are limited by Internal Revenue Code Section 129 as to the acceptability of various child-care arrangements for nontaxable reimbursement. The required Dependent Care Assistance Plan (see Appendix) drafted by the employer must stipulate which programs are allowed.

Many employers and their legal counsel believe that it is the responsibility of the employee to assure that these criteria are met. Typically, the employer requires no more than a statement or signed affadavit from the employee as to the amount of child-care expenses incurred. Other employers monitor the use of the child-care dollars they provide more closely and require receipts, social security numbers, and the like, to assure that the child-care arrangement qualifies for nontaxable reimbursement.

According to the Wyatt Company, a benefit-consulting firm: "To the extent that the employer is providing nonqualifying child care, it is still deductible to the employer, but taxable to the employee. The employer is still involved because he is responsible for reporting and withholding income. Most of the employers we work with require employees to fill out a claim form to allow the employer to determine whether the care meets the requirements."[2] This difference of opinion will be settled when regulations on Dependent Care Assistance Plans are promulgated.

[1] Martin O'Connell and Carolyn Rogers, "Child Care Arrangements of Working Mothers: June 1982." *Current Population Reports*, No. 129, November 1983.

[2] Cited in *Employers and Child Care: Development of a New Employee Benefit*. Bureau of National Affairs, Washington, DC, 1984, p. 16.

Expectations

Most employers providing financial assistance for child care expect that their investment will yield a return through improved recruitment, retention and productivity, and through lowered absenteeism and stress levels. This was particularly true for the companies offering vouchers, the option requiring the greatest investment of funds. The employers with comprehensive cafeteria plans indicated that productivity gains are expected from the restructuring of their benefit plans. It was not clear whether any additional outcomes were expected from the provision of a dependent-care option.

Child care is often marketed to the business community as a strategy for solving a range of management problems. It is clear from this and other surveys that many employers *believe* this connection to have some merit. Yet the research to date does not adequately substantiate these claims. None of the research has singled out the financing options, so that most conclusions are drawn from the experiences of employers (mostly hospitals) providing on-site day-care centers. On the basis of anecdotal evidence, the perception is confirmed, but no company has conducted the kind of research that would definitively answer the question.[3] This kind of research is difficult to conduct and often requires invasive questioning of employees. Many companies with child-care programs also offer a range of other family supportive benefits. It thus becomes difficult to attribute a change in employee behavior or attitudes only to the child-care component of their benefits and services.

The effects of child-care financing programs will ultimately depend on the availability of preferred forms of care and on the quality of the child care purchased. If that care arrangement is unstable, the employee may be absent or tardy. Some employers contribute to efforts to expand the supply or improve the quality of child-care services in addition to providing financial assistance to the employee. The unanswered question is whether the parents use the financial assistance provided by the employer to purchase better quality care, or whether they keep constant the amount spent on child care and shift their own resources to other household expenses. None of the surveyed companies have collected information that would answer these questions, and only five of thirty-eight respondents expressed an interest in conducting such research in the future.

Financing Options

Bearing in mind the overall patterns of response, the unique structures of each financing option are described below.

Voucher Programs

In a voucher program, an employer subsidizes a portion of the employee's child-care costs incurred at programs selected by the parent. The company may put the money in the employee's paycheck or pay the provider directly. This study identified fewer than 25 U.S. companies offering this direct form of financial assistance for child care.

The voucher program is less popular than other financing mechanisms because it can become an expensive option and it may serve only a limited number of employees. The amount of subsidy needs to be high in order for the parent to benefit from any meaningful reduction in child-care costs. Most companies limit eligibility to certain income groups or ages of children as a way to control the cost of a voucher program. For example, Polaroid Corporation covers a portion of the child-care costs for employees whose family incomes are less than $25,000. Measurex Corporation will pay for some child-care costs only during the child's first year of life. A company may also control voucher costs by limiting them to certain kinds of programs. For example, vouchers at Minnesota Mining and Manufacturing (3M) can be applied only to sick-child care programs; while at Baxter Travenol Laboratories, Inc. in Deerfield, Illinois and Palmetto General Hospital in Florida, usage is limited to a selected group of day-care centers. All employers with voucher plans set a maximum on the amount they will contribute to their employees' child-care costs—an amount based either on family income or cost of care.

According to child-care advocates, vouchers represent the greatest commitment to child care because they require a direct employer contribution. However, companies may be concerned about their potential cost while there is an attractive alternative—salary reduction—that offers employees similar savings at *no* cost to the employer. Smaller employers, unable to comply with salary-reduction regulations, may find vouchers attractive and affordable for a limited number of employees. Generally, however, widespread growth of voucher programs in the future is unlikely.

This conclusion was confirmed by The Voucher Project, a demonstration project conducted by the Phoenix Institute of Salt Lake City, Utah and funded by the Department of Health and Human Services. The project was designed to increase the number of employers offering child-care vouchers to their employees. The final report of The Voucher Project, 1984, explains:

[3] Three national surveys of employers with child-care programs have attempted to gather information about the effects of child-care provision: Women's Bureau, U.S. Department of Labor, *Employers and Child Care: Establishing Services at the Workplace*. Washington, DC: U.S. Government Printing Office, 1982; Sandra L. Burud, Pamela R. Aschbacher, and Jacquelyn McCroskey, *Employer-Supported Child Care: Investing in Human Resources*. Boston: Auburn House, 1984; and, Renee Y. Magid, *Child Care Initiatives for Working Parents: Why Employers Get Involved*. New York: American Management Association, 1983.

Two experimental studies have attempted to show the productivity effects of child care provision: George Milkovich and Luis Gomez, "Day Care and Selected Work Behaviors," *Academy of Management Journal*, March 1976; and Ann Gilman Dawson, Cynthia Sirk Mikel, Cheryl S. Lorenz, and Joel King, *An Experimental Study of the Effects of Employer-Sponsored Child Care Services on Selected Employee Behaviors*. Washington, DC: Office of Human Development Services, Department of Health and Human Services, 1984.

A review of several studies appears in an article by: Thomas I. Miller, "The Effects of Employer-Sponsored Child Care on Employee Absenteeism, Turnover, Productivity, Recruitment or Job Satisfaction: What is Claimed and What is Known," *Personnel Psychology*, 1984, p. 277.

"Since the project did not provide matching funds as incentive for employers to try the voucher system, staff had a hard time selling the idea on its own merits. We concentrated our efforts on fairly large businesses—500 employees or more—who employ women at low salaries. We found that the businesses who seemed most receptive were the younger, progressive companies that were highly involved in computerized data networking or electronic technology. We received a wide range of responses to our presentations, but concern with expenses was most outstanding. We found employers who were genuinely sensitive to employees' needs, but didn't feel involvement in a voucher system was affordable."

Design of the Subsidy

The simplest approach to vouchers appears to be a flat-rate reimbursement provided to all employees, regardless of the cost of care or family income. To illustrate: Zayre Corporation in Boston reimburses its home-office employees up to $20 per week to meet child-care expenses. Fay's Drug Company in Liverpool, New York, provides full-time employees with "certificates of eligibility," worth $15 a week, toward the cost of child care.[4] Baxter Travenol Laboratories subsidizes child care at a rate of $3.50 per child per day for employees using one of two child care centers in the community. A three-year agreement between the *Village Voice*, a New York weekly newspaper, and District 65 of the United Auto Workers provides a $500-per-year child-care subsidy to employees with preschool children.

However, most companies base their vouchers on a fixed percent of total costs, establishing a maximum ceiling on the cost of care for which reimbursement may be received. For instance, Cambridge Plan International had a voucher plan in 1982 covering 50 percent of the cost of care, with limits of $80 per week for infant care (the company reimbursed the employee $40), $50 per week for preschool care, $35 per week for after-school care, and $20 a day for overnight care due to business-related travel.

Some employers may establish reimbursement rates in accordance with public-sector policies. When the Ford Foundation established its Child Care Assistance Policy in 1972, it paid 50 percent of the typical weekly rate paid by employees—with a small additional amount paid for those using licensed care, which is usually more expensive. By 1979, the reimbursement rates were no longer adequate and were changed to match the rates set by the New York City Agency for Child Development and the U.S. Department of Agriculture for care in Manhattan. According to the Ford Foundation's child-care policy:

"This new method of calculating reimbursement levels eliminates the necessity for frequent surveys of employee child care costs... Although the previous flat-rate reimbursement paid a larger proportion of the costs for those employees who chose the least expensive method of child care, the new reimbursement policy eliminates the inadvertant bias toward less expensive methods."

Another kind of voucher, with varying reimbursement rates, is related to family circumstances. The Polaroid Corporation offers a subsidy on a sliding scale, based on family size and income. The highest subsidy (80 percent of the cost of care) is paid to the lowest-earning employees, and the rate decreases to cover 10 percent of the child-care costs for families of four with incomes of $25,000 (Table 4). Polaroid defines its voucher program as a service, rather than a benefit, because of its targeted use for lower-wage-earning employees.

Eligibility

In small companies (described here as those with fewer than 500 employees), where a small number of employees are in a position to take advantage of the subsidy, eligibility is not usually limited. In larger companies, vouchers may be limited to those in greater need. Polaroid limits eligibility for vouchers to employees with family incomes of $25,000 or less. The Ford Foundation offers child-care assistance to full-time employees with gross family incomes of $25,000 or less. (The original income maximum of $20,000 was increased in 1980.) The income restrictions on eligibility help to keep overall costs low, but they prevent most professional staff from participating in the program.

Another goal for a voucher program—to reduce the amount of maternity leave taken by female employees—may also ultimately limit eligibility. At Measurex Corporation in Cupertino, California, a subsidy of $100 per month is available to employees during the child's first year of life. *Parents* magazine in New York offers a flat subsidy of $500 to be used during the first three months after childbirth. The intention here is to help new parents afford the high costs of infant care,

Table 4: 1984 Subsidy Rates for the Voucher Plan at Polaroid Corporation

	Number of Family Members		
Total Family Income	*2-3*	*4-5*	*6 or more*
$11,000	60%	70%	80%
13,000	50	60	70
15,500	45	55	65
17,000	40	50	60
19,500	35	45	55
21,000	30	40	50
23,500	25	35	45
25,000	20	30	40

Note: The amount of subsidy (which is provided on a sliding scale) is based on total family income and the number of members in the employee's family.

[4] "Experiment With Vouchers in Onondaga County," *Business Link*, Fall, 1984, p. 6. Published by Center for Public Advocacy Research, New York, NY.

so that burdensome child-care expenses do not delay return to the job. Although the subsidy levels offered by these two employers are low when compared with an average infant-care cost of $100 a week, the program has been effective as an incentive to return from maternity leave. Professional employees are more likely to use this subsidy than are clerical employees, whose maternity leaves are typically shorter.

Eligible Services

Most companies allow vouchers to be applied to any child-care option covered by the child-care tax credit. Companies that are concerned about the quality of the programs their employees select may arrange for vouchers to be accepted by specific community programs. For example, Palmetto General Hospital in Florida pays 50 percent of the cost of care for employees enrolling in one of the several day-care centers that the hospital has evaluated and accepted for participation in the program.

Other companies target vouchers to specific aspects of the child-care problem. 3M inaugurated a pilot program in March, 1984, providing a subsidy for employees needing services for sick children. (The policy was made retroactive to January, 1984.) The subsidy may be used to purchase care provided by in-home health-care workers from Child Care Services, Inc., a program affiliated with St. Paul's Children's Hospital. Since most parents must continue paying for their regular child care when the child is absent due to illness, the costs of a separate, sick-child-care service increases the financial burden on the parent.

A study of care for sick children in the Twin Cities area indicated that the costs of in-home sick-child-care services range from $4 to $6 per hour—an additional cost to the family of $36 to $50 per day.[3] 3M employees pay only $2.00 an hour for sick-child-care services. The company made a one-year grant of $4,000 to Child Care Services, Inc. to cover the remaining $4.25 charged by the agency. This system does not require reimbursement by 3M. The company estimates that sick-child-care services will cost $10,000 in 1985 and will serve several hundred employees.

Utilization and Cost

Depending on the utilization and subsidy rates, the costs of voucher programs vary greatly among employers. The voucher is typically used by a small minority of employees, reflecting the demographic characteristics of the employee population or the eligibility criteria established by the company.

Since the program's inception at the Ford Foundation, the number of participants has never exceeded 28. This number represents nearly 10 percent of eligible nonexempt employees. In 1983, the total cost of the Ford Foundation's Child Care Assistance Policy for all users was $10,505, providing each parent with an average of $875 per year to cover child-care expenses.

Vouchers at the Polaroid Corporation, whose eligibility criteria are similar to those at the Ford Foundation, are used by a larger employee pool. Of 14,000 employees, an average of 100 employees have applied for vouchers each year since 1972, although this number fluctuates from year to year. At Measurex, 46 employees (or 4 percent of its 1,150 employees) have taken advantage of the voucher since the program's inception in 1975. An average of 14 employees per year use the subsidy for a period of nine to ten months after returning from maternity leave. The company estimates the costs to the company at $10,000 per year. The highest utilization rate was reported by Title Data Corporation of Colorado. One-quarter of its 100 employees (75 percent of whom are female) received a subsidy worth 50 percent of the cost of care in 1983. The company spends up to $18,000 per year on its voucher program, an average of $750 per employee per year.

Baxter Travenol Laboratories offers its subsidy to 2,000 employees working in the corporate headquarters area. Each year, approximately 70 employees have taken advantage of the $3.50 per day subsidy which saves the employees roughly $788 per year on their child care expense, and which costs the company approximately $55,125 per year.

As shown in Table 5, Cambridge Plan International had the most expensive voucher program. In 1982, over $100,000 was spent on 121 employees, serving 190 of their children. When the company needed to cut back on other services, it retained the child-care program because it felt that the employee and public-relations advantages outweighed the cost concerns.

Administration

Most companies provide the subsidy through a separate monthly payment to the employee. Prior to January, 1982, this amount was considered to be taxable income to the employee. For instance, in 1970, the employees at the Ford Foundation received reimbursement after deduction of the appropriate withholding taxes. The total expense of child care—both the Foundation's share and the employee's uncovered costs—could be claimed for the Child Care Tax Credit. After passage of the 1981 Economic Recovery Tax Act, however, the Ford Foundation drafted a Dependent Care Assistance Plan and offered the subsidy on a nontaxable basis and the Foundation's share could not be claimed for the tax credit.

The Polaroid Corporation is one of the few employers to pay the subsidy directly to the provider. According to the firm's Manager of Employee Services: "This decision was made by the Day Care Committee that designed the voucher and it has turned out that our employees prefer that we continue paying the provider directly." Payments are made on

[3] "Sick Child Care Services Available in Metro Area," *NEXUS*, February 1984, p. 3. (Available from Greater Minneapolis Day Care Association, 1006 West Lake Street, Lehmann Center, Minneapolis, MN 55408).

Table 5: Features of Voucher Programs, Selected Companies

Company	Title Data	Measurex	Polaroid[1]	Ford Foundation[1]	Cambridge Plan	Baxter Travenol
Total number of employees	100	1,150	14,000	350	950	1,500
Percentage of female employees	75%	37%	58%	68%	58%	N.A.
Number of employees using plan	25	14	100	25	121	70
Percentage of employees using plan	25%	4%	Less than 1%	10%	13%	N.A.
Subsidy rate	50% of cost	$100 a month (for 1 year)	10-80% of cost	50% of cost	50% cost of care	$3.50/day
Average yearly cost per employee	$750	$900-1,000	N.A.	$875	$1,200	$788
Total yearly cost to employer	$14-18,000	$10,000	N.A.	$10,505	$120,000	$55,125

N.A. = No Answer

[1] Care provided to employees whose family incomes are less than $25,000.

a quarterly basis, but special arrangements can be made with centers that have cash flow problems.

For most employers surveyed for this report, payment to providers presents an unnecessary administrative burden. Some community groups have recognized this potential problem and have designed programs that facilitate employer provision of child-care subsidies. According to a report describing the Day Care Fund in New York City:

> "The Day Care Fund will serve as the 'Blue Cross' for child care, marketing a variety of child care plans to companies, and making third-party payments to service providers. This removes the administrative burden from the employer since the responsibility of the Fund is to assure program quality, establish subsidy rates and handle complaints. The Fund can help parents spend their employers' dollars more wisely through its provision of information services. For child care providers, the Fund would establish a centralized mechanism for integrating employer support, rather than forcing providers to cope with a variety of mechanisms that individual employers might establish."[4]

A similar program was established by the Greater Minneapolis Day Care Association (GMDCA) in conjunction with Parents in the Workplace. Their Employee Child Care Assistance Fund allows employers to contribute to the Fund and earmark moneys for their employees. However, no companies have taken advantage of this opportunity in either Minneapolis or New York City. This can be explained, in part, by corporate involvement in flexible benefits which does not typically require an outside administrative agency.

Other communities have had some success with this approach with smaller employers. For example, Austin Families Inc. in Texas offers this administrative service and currently operates child-care voucher programs for three employers: (1) Austin Independent School District Transportation Department, which covers 50 percent of employees' child-care costs; (2) Seton Medical Hospital, which pays $50 per month to families meeting income or family size guidelines; and, (3) Austin Regional Clinic, which covers 20 percent of child-care costs for employees with family incomes under $30,000 a year. The programs for the latter two began in early 1984 as part of a demonstration project with Community Development Block Grant funding and are not being continued by the employers with their own funds.

The Onandaga County Child Care Council administers the voucher program for Fay's Drug Company in upstate New York. The agency collects the vouchers from the child-care providers, pays them directly, and bills Fay's Drug on a quarterly basis.

[4] Dana E. Friedman. *The Day Care Fund: Facilitating Employer Support for Child Care.* New York: Child Care, Inc. (125 West 109th Street, New York, NY 10025), 1983, p. V.

An Assessment of Voucher Programs

(Based on the experiences of identified companies)

Advantages

- Promotes parent choice.
- Supports community child-care services without selecting among deserving agencies.
- Limits administrative responsibility if paid through payroll deduction.

Disadvantages

- Can be costly, unless eligibility is limited.
- Limitations may cause equity problems.
- If community care is not available, or is not of high quality, then employer subsidies will not significantly address the more serious child-care problem facing employees.

A Corporate-Community Experience

As a result of state and local government experimentation with voucher programs, community agencies are already organized to extend services to the business community. Most of these agencies also provide information and referral services to help parents shorten their search for an appropriate child-care arrangement. Community Coordinated Child Care (4-C) of Central Florida receives state voucher money to cover a portion of child-care costs for low-income families. In 1978, McKinnon Corporation, a major citrus grower, was approached by 4-C because the agency found that public moneys were not always available for the corporation's employees during peak seasonal needs. The company had considered starting a day-care center, but realized that the farm workers would not be able to cover operating expenses. McKinnon Corporation agreed to cover 50 percent of the cost of care for any employees that 4-C could not help with public money. McKinnon Corporation then interested South-Lake Apopka Citrus Growers Association, a citrus packing house, to contract with 4-C in a similar arrangement. In anticipation of expanding this service to other employers, 4-C received IRS approval to create the Child Care Assurance Plan. Currently, six employers are contributing funds to 4-C to have it manage assurance plans for their employees.

In the Spring of 1984, 4-C contracted with two divisions of W.B. Johnston Properties: J.P. Hotels that manages Marriott and Holiday Inns, and North Lake Foods, Inc., franchisers of Waffle Houses, to provide the Child Care Assurance Plan to its employees. Both divisions run 24-hour-a-day operations and were faced with scheduling difficulties and employee absenteeism due to child-care problems. The success of the program in Orlando led to the expansion of the program to Atlanta, Jacksonville and Richmond and future plans to offer reimbursement in other parts of Florida and Virginia. (Only Florida has a state voucher system, so that where the program has been replicated in other states, there is no mechanism by which the community agency can allocate state funds to eligible employees before applying their employer's voucher funds. The agencies can advise employees to apply for government subsidy, but cannot distribute available state funds as Florida agencies can.) As explained by the Vice President of Organizational Development for J.P. Hotels and North Lake Foods: "This expansion was possible because 4-C in Orlando was able to identify local agencies that could replicate the Child Care Assurance Plan." This is the only instance we have come across of a multisite corporation that currently organizes a voucher program to serve employees in a variety of locations in different states. Several companies are considering the establishment of a national vouchering system to assist multisite corporations in this process.

As government agencies experiment with vouchers, and information and referral agencies proliferate, the opportunities for companies to provide vouchers, or other forms of financial assistance, will expand. In addition to eliminating the company's administrative responsibility and cost, these community agencies offer counseling services that can help parents become wise consumers of the day-care dollars made available by their employers.

Discount Programs

Many companies have negotiated reduced rates for their employees on rental cars, hotels and sports events for some time. In a similar manner, companies can now arrange for employee discounts at local day-care centers. An estimated 300 employers currently contract with a profit-making chain of centers or with a single, large center in the community. Most programs offer a 10-percent discount to the employee and, in about one-half of the contracts, the employer contributes 10 percent of the fees so that employees benefit from a 20-percent reduction in their child-care costs.

The discount approach is relatively inexpensive for the employer, because their contribution is limited to 10% of expenses or because there is no corporate contribution and, sometimes, because of limited use by employees. While employees may save between $250-$500 per year on child-care expenses, the centers available under the contract may be inconvenient for the parent, inappropriate for the child, or have no space for additional children. Vendors benefit from the discount program because they are able to fill unused spaces.

The Vendors

Most of the national day-care chains market some kind of discount program to employers. The experiences of three national chains interviewed for this study are described below:

- **Kinder-Care,** the largest chain with 900 day-care centers serving 95,000 children in 40 states, has 75 companies participating in its Kindustry discount program. As of late 1984, five companies also contract with Kinder-Care to run day-care centers for their employees' children (CIGNA Corporation, CT; Allendale Insurance, RI; Union Mutual Insurance

Corporation, ME; Campbell Soup, NJ; and, Walt Disney World [two centers], FL). Generally, companies participating in the Kindustry program match the center's 10-percent discount. Companies taking advantage of a payroll deduction option are billed the first of every month for 90 percent of the fees. Other companies are billed each month for their 10 percent contribution, and employees pay their portion of the fees directly to the center. Kindustry billing is coordinated at corporate headquarters in Montgomery, Alabama, and dispersed to individual regional offices where they have company accounts.

• **La Petite Academy,** the second largest chain of centers, has over 400 programs operating in 24 states. In all but four of its forty-seven regional divisions, children are enrolled in centers on the basis of the "Employer Care" discount program. The 155 companies working with Employer Care participate at no cost, but their employees receive a 10-percent reduction in fees. Approximately 1,000 families receive this discount.

• **Children's World,** a chain of 160 centers serving more than 20,000 children, offers a range of options to the 17 employers participating in its "Career Care" programs. In addition to the matching tuition reduction program, it also allows a variation for employers not ready to make a financial commitment. Through this "integration program," a 5-percent discount is offered to company employees for a period of six months in exchange for internal publicity about the program. During this time, Children's World closely monitors employee use and satisfaction. In some cases, the discount increases to 10 percent when the number of employees using the Children's World center reaches a predetermined level. In this way, the company has an interest in seeing that the program grows, which helps the centers increase enrollment. In one newly established center, the Career Care program has resulted in almost exclusive use by the employees of one company.

The discount program is typically provided by chains of centers because they can offer companies a choice of locations, enabling a greater number of employees to participate. The discount is offered exclusively by proprietary centers because they are likely to have the financial flexibility to reduce fees, and because nonprofit centers cannot guarantee a large number of spaces or show favoritism to any one employer. Vendors that offer discount programs are also likely to serve three-to-five-year-old children in an urban area because these are the programs that are most likely to be under-enrolled. The discount program is part of the center's marketing strategy and, as a result, an employer contribution is often not required.

The vendor's marketing strategy often involves encouraging parents who use the center to recommend the discount program to their employers. Employee endorsement stimulated a number of surveyed companies to enroll in the discount program. The vendors also provide promotional materials that are widely distributed throughout the company and assure additional publicity for the vendor.

According to the National Association for Child Care Management (NACCM), representing private, proprietary child-care-center owners and operators, the occupancy rate among its members is approximately 80 percent. The Executive Director of NACCM, explains:

> "Our members are building larger centers in high-growth areas, allowing population factors to serve as the driving force. These centers are built to accommodate community needs and are not designed to be 100-percent filled at first. There is the expectation that slower growth will produce a more stable program."

The three chains interviewed, as well as NACCM, expect continued growth in the number of employees participating in discount programs.

Participating Companies

Companies in the survey that offered discount programs are most likely to be financial institutions, hospitals or other service industries. They are also, typically, nonunionized and have high proportions of female employees. Employers with discount programs tend to be smaller in size than employers providing other forms of child-care assistance.

Among the 14 companies with discounts responding to The Conference Board's survey, the median company size was 950 employees, with a range from 3 to 3,400 employees (Table 5). According to the National Public Relations Director of KinderCare: "The *very* large companies are still holding out—there is so much red tape—but the medium and small companies are interested."

Equitable Life Assurance was one large company that tried the discount program on a pilot basis in three cities, but discontinued its involvement after two years of participation (see page 19 below). The 2,500 employees in Honeywell's Residential Division are eligible for discounts at a Children's World Center and two other centers in Minneapolis. And a fast-food chain with 11,000 employees offers discounts only to the 650 employees at its headquarters. A large, multisite corporation with a desire to offer some child-care benefit to employees in all locations is likely to find that a national contractor may not have a concentration of centers in needed locations. As a result, employee use may be severely limited or the company may need to contract with several providers.

Utilization of Programs

The number of employees using the discount program in any one company is typically low. Among the 209 companies participating in the discount programs of the three national chains described above, 2,259 children receive care under reduced fees. Parents may have more than one child enrolled, so that the actual number of *employees* who benefit from a discount program is even smaller. Kindustry estimates that, on average, 35 to 40 employees per company apply for the discount (ranging between one and 80 employees per company). Among nine companies with 100 employees or more responding to this survey, all but one employer reported utilization rates of less than

Table 6: Features of Discount Programs

	Fast Food Chain	*Phil Crosby & Associates, FL*	*Christian Hospital, MO*	*Olympia Fields Medical, IL*	*Brookwood Medical, AL*
Vendor	Kinder-Care	4C of Central Florida	Kinder-Care	Kinder-Care	Kinder-Care
Estimated Percentage of Utilization	2	3	4	2	2
Maximum Amount Available to Employee	10% of fees	50% of fees	$520 a year	No limit	20% of fees
Method of Distribution	Pay to provider, monthly	Pay to provider, monthly	Pay to provider, regular paydays	Employer portion paid to Kinder-Care headquarters	Pay to provider, regular paydays
Yearly Cost per Employee	N.A.	N.A.	$500	$100	$410
Total Employer Cost, Yearly	$1,500-$2,000	N.A.	$50,000	$2,000	$4,800
Total Number of Company Employees	11,000 (discount available to 650 at headquarters)	130	2,700	870	1,800

N.A. = no answer.

4 percent. The exception was a Florida bank with 112 employees, 15 percent of whom used the discount.

Since there is turnover each year among parent users, a larger group of employees eventually receives the benefit. One limitation of the utilization data is that none of the day-care chains contacted knew how many employees had tried to enroll their children but could not do so because the center was filled. There are also no data on the number of employees using discounts who switched their child-care arrangements in order to take advantage of a less expensive program. The low participation rates for discount programs may indicate that cost is not the most important criterion in selecting a child-care program.

Surveyed companies estimated that most of the discount users were female professionals. Fathers participated as often as mothers in three of the companies reporting. The large fast-food chain and the Florida bank were the only two of eleven employers reporting that said mothers in clerical positions constituted the largest user group. Among the five hospitals reporting that the discount was most frequently used by women in professional jobs, it is likely that the program was designed with nurses in mind.

Decision Making

Most of the employers responding to the survey indicate that the idea for child-care assistance came from an employee. An Illinois manufacturer with 750 employees was motivated by the personal problem of a manager. Apparently without employee urging, one hospital explained it "wanted to be proactive and not reactive."

All of the 11 employers with discounts and at least 100 workers conducted surveys to determine the scope of need and preferences for a solution. All but two first considered an on-site child-care center. One hospital, which closed its on-site center in favor of the discount program, explained: "We wanted a more effective center that was less costly." Another hospital is in the process of proposing that a seven-day, twenty-four-hour, on-site center be developed.

Expectations

Expectations of reduced absenteeism, better morale, and/or recruitment advantages apparently prompted most companies to respond to the child-care concerns of their employees. A majority of these employers said they would like to study the effects of the discount program in the future, but none had conducted, or is in the process of conducting, such research.

Three Company Experiences

Varied experience with the discount program and two of the national chains is reflected in the three cases studies that follow.

Honeywell, Inc. In July, 1980, Honeywell's Women's Task

Force at corporate headquarters published a study documenting a serious child-care need among employees. In March, 1981, a Working Parents Task Force was convened to develop solutions to the problem of working parents. The task force developed a list of 14 recommendations, including flexitime, parent-education seminars, and financial assistance for child care. Each division of the company was encouraged to consider adopting some of these programs for the parents it employs.

The Residential Division, employing nearly one-quarter of the Honeywell work force located in the Twin Cities, formed a task force similar to the corporate-level model. The effort was motivated by a group of young parents who were, according to a company spokesperson, "insistent, as well as good organizers." Their first project was to organize a Parent Fair, at which community agencies set up booths to display and discuss their services. They also designed a brochure for new employees, explaining all aspects of Honeywell policies that are family-supportive. The division's Director of Employee Relations became a staunch supporter of the task force after becoming a single parent.

While an on-site center was being considered, the task force was notified that a new Learning Tree day-care center (affiliated with the Children's World chain) was about to open one-half mile from the Honeywell division. One employee, whose child was enrolled at another Learning Tree center, endorsed the quality of the program, and a decision followed to contract for 60 slots at the new center at a 10-percent discount. If fewer than 60 division employees used the center, then the discount would amount to only 5 percent of weekly fees. Within seven months, more than one hundred employees at the Residential Division (approximately 4 percent) had enrolled their children in the Learning Tree center. Shortly after this, two other centers in the community began offering the discount to Honeywell employees.

Honeywell is currently considering a flexible benefits plan that would include dependent-care assistance, but the Residential Division plans to keep its discount arrangement with Learning Tree as well.

Company K—A Fast Food Chain. In early 1982, the child-care issue was raised at one of the company's semiannual employee meetings. A small group of managers met to discuss the suggestion, and decided to pursue it. A survey was prepared and circulated among the 650 employees at the headquarters office. Because space was at a premium, an on-site solution was abandoned. In looking into other options, one employee came forward to recommend a nearby Kinder-Care center. The Director of Employee Services believed that this employee was already using the center.

Company K decided to subsidize 10 percent of the child-care costs for those employees enrolling in any of the Kinder-Care centers in the area. Begun in June, 1982, and intended as a six-month pilot project, the discount was still available as of August, 1984. Approximately 15 of the company's employees use the discount. When asked about the low utilization, a company official explained: "Parents are satisfied with the quality of the Kinder-Care centers, but there are some needs these programs can't meet."

The discount program was developed on a pilot basis to determine whether it might be expanded to other facilities located in other parts of the country as employees outside headquarters have expressed their desire for child-care assistance. The Employee Relations Director remarked: "This is a continuing problem for the multisite employer. If you institute such a benefit, it could be more of a detriment than a boost if not offered companywide. You end up creating an 'us-them' environment." If the discount program is to be expanded, the company will consider using Kinder-Care in other cities. If Kinder-Care does not have a facility in certain locations, the company might consider providing a 10-percent subsidy and letting its employees choose their own child-care arrangements.

The Equitable Life Assurance Society of the United States. The subject of child care emerged during a meeting of a women's task force that used to meet regularly with the president. A Child Care Task Force, formed to investigate other companies' child-care programs, concluded in its final report in June, 1980: "The Equitable should encourage the growth and development of professional child-care services by lending its support as a corporate citizen."

Several options were considered, including a company-owned and operated facility and a voucher program. The task force favored a financing approach, because of "the potential long-term effects, the control Equitable could have over this type of program, and the potential for augmenting the good will of the community and enhancing company pride."

This recommendation led to a contract between the Equitable and Kinder-Care in March, 1981, establishing a pilot project in three cities with Equitable offices: Albuquerque, NM; Columbus, OH; and Atlanta, GA. Equitable employees could enroll their children in these centers on request. A 10-percent discount on child-care services was given by Kinder-Care. Equitable paid an additional 10 percent of the basic cost, and employee payments to Kinder-Care were made through payroll deductions.

The pilot was discontinued after 18 months. One of the chief concerns was the low utilization by employees—averaging a combined total of 25 per month at all three sites. Participating employees were very satisfied with the Kinder-Care centers, but some employees had difficulty changing their current arrangements. Part of the problem was that the program was launched at the end of the school year. Others were unable to afford the Kinder-Care program even with the discount. It was also realized that cost is not the sole basis of the parent's choice of child care. As an Equitable evaluation noted:

> "Even if the parent can afford Kinder-Care, many other factors, particularly location and perceived quality of care, are part of the decision-making process. Therefore, unless a Kinder-Care center is conveniently located and offers the type of care an employee wants, he or she may not choose to use Kinder-Care even if we offered up to a 50-percent discount."

An Assessment of Discount Programs

(Based on the experiences of identified companies)

Advantages

- Low cost. Many vendors do not require an employer match. A 10-percent match costs approximately $5 per week per employee.
- Little administrative responsibility. The only necessary administrative expenses are preparation of a written Dependent Care Assistance Plan (DCAP), promotion of the discount program, and development of a payroll-deduction system.
- Can expand with need. Additional slots can be guaranteed as more employees apply for the discount..
- Can retrench as need demands. The program can be discontinued or reduced with few administrative problems and little employee hardship..
- Limited liability, such as would exist with an on-site center.
- Favorable publicity, particularly as vendors promote their centers to the media and other employers.
- Good employee-community relations. This commitment is often seen as an investment in social responsibility.

Disadvantages

- Limits employee use. Only those who find the vendor's programs conveniently located or suitable for their children will enroll. This may create a problem of equity for employees with other types of child-care needs or preferences.
- Does not promote employee choice. The company, in choosing a vendor, is endorsing its quality. Some employees may disagree.
- Insufficient vendor capacity. Employees could be turned away or the vendor may not have facilities in all needed locations.
- Need for a written DCAP. Small employers may see this as an administrative burden.

In one of the pilot cities, low utilization was also attributed to the small numbers of employees and the limited number of Kinder-Care centers. Kinder-Care also felt that the Equitable did not adequately promote the discount option to its employees. In addition, there was a change in Equitable's management midstream and some cutbacks in Equitable services.

An Equitable manager observed the problem of collaborating with an organization operating on a different schedule. For instance, when Equitable instituted flexitime, the centers were unable to accommodate the varied schedules of employees. Another problem associated with a national vendor contract was the varied quality of programs at the local level.

After a total cost of $3,600 (or approximately $235 per employee), the Equitable concluded that if the benefits it "hoped to derive from this program are improvements in productivity, absenteeism, and so on, the conclusion would have to be that there is no evidence that these goals are being achieved." However, the company further concluded: "The short-term results show that Kindustry has been a relatively inexpensive benefit that has had a substantial public-relations impact." According to an Equitable Vice President:

> "The primary reason, then, for discontinuing the discount program centered on Equitable's desire to develop a service that would be equally accessible to our work force in hundreds of different locations across the country. It would have been virtually impossible to identify child-care providers nationwide with which we could then establish a program similar to what we had with Kinder-Care."

While the employees participating in the program still receive the discount as long as enrollment is not severed, the Equitable has moved to provide other types of child-care assistance. In December, 1983, a Child Care Information Service was launched that provides information to parents through a series of articles and taped presentations. Equitable is also engaged in a pilot project with Child Care, Inc. to provide information and referral services to employees in the New York City area. Management feels that even though it does not provide financial assistance, the information services it does provide can help parents learn to save money and choose quality care and make the best use of their day-care dollars.

Flexible Benefit Programs

A flexible benefit program, or "cafeteria" plan, allows employees to choose from a "menu" of taxable and nontaxable benefits those that suit their individual needs. The interest in flexible compensation stems from both social and economic change. The presence in the work force of women, two-earner families, single parents, and older and younger people—as well as changing and varying expectations of these groups—points up the problem of satisfying a diverse work force with one traditional set of benefits. The growing popularity of flexible benefit programs can be attributed to employers' desires to respond to diversity while controlling benefit costs.

There are many forms of flexible compensation, and each company seems to apply its own creative touch to the actual design of a particular model. According to several benefit-consulting firms, there were an estimated 600 flexible benefit programs in place at major corporations in late 1984, and between 50 and 75 percent of them include dependent care as an option.

History

Most flexible plans have been implemented since 1982. Although TRW, Inc. and Educational Testing Service (ETS) pioneered flexible benefits in the early 1970's, widespread growth was inhibited by the absence of definitive rules on the doctrine of "constructive receipt": With passage of ERISA (Employee Retirement and Income Security Act) in 1974, Congress banned all kinds of benefit plans permitting choice. If an employee was given a choice between taxable and nontaxable benefits or cash, the employee was in "constructive

receipt" of the benefit and, therefore, the value of all benefits—even those that were nontaxable—would have been subject to taxation.

This doctrine of constructive receipt was reversed in the Revenue Act of 1978. As a result, a choice of benefits could be offered and no tax would be imposed on the nontaxable benefits selected. While Section 125 of the Internal Revenue Code made it clear that a choice of benefits was allowed, many employers stayed away from flexible compensation because of the absence of Internal Revenue Service regulations providing guidelines for the design of such benefit plans. The regulations finally proposed in May, 1984, proved to be controversial. The novelty and administrative complexity of flexible benefits have further inhibited the growth of these plans.

Another change in the tax law brought child care into the debates on flexible compensation. In the Economic Recovery Tax Act of 1981, (ERTA), dependent care was made a nontaxable benefit, and, thus, a convenient option to include in flexible plans. One of the factors inhibiting the growth of employer-supported child care has been employer concerns about equity. Employers are concerned that employees without young children would feel they should receive a benefit of equal value. Since flexible benefits became legal, and child care was deemed a nontaxable benefit, financial assistance for child care has grown along with flexible plans. (See box, p. 23.)

The Structure of Flexible Plans

There are a variety of ways to offer a choice of benefits to employees while containing—or reducing—benefit costs for the employer and providing more tax-effective compensation to the employee. For the purpose of understanding how dependent care becomes an option in a flexible plan, the various alternative plans are grouped into two categories of flexible compensation. The first category includes the more comprehensive approach to benefit planning—where the basic package of benefits has been redesigned and employees have use of flexible credits to purchase desired benefits. Credits are usually generated by employer contributions and are placed in a credit account for the employee. Among 100 so-called cafeteria plans surveyed by Hewitt Associates, 86 had a flexible spending account. Of these, 74 percent offered dependent care as one of the benefit choices.[7]

The second category of flexible compensation surveyed and analyzed for this report is the free-standing, flexible spending account. The basic benefits package is unaltered, but a spending account is available for a variety of taxable and nontaxable benefits. The account may include an employer contribution, but is usually funded by salary reduction. Some employers also allow the value of unused vacation days or a portion of savings and profit-sharing plans (401[K]) to be applied to the flexible spending account. According to estimates by national benefit consultants, as many as 1,000 employers—including major corporations, small professional firms, municipalities and other nonprofits—provide flexible spending accounts. They further estimate that 50 to 75 percent of these plans include dependent care.

Dependent care in a cafeteria plan can only be funded through a flexible credit system or spending account. Therefore, all cafeteria plans with dependent care have established some kind of flexible spending account, which may or may not be funded through salary reduction. The purpose of distinguishing the comprehensive cafeteria plans from stand-alone, flexible spending accounts is to highlight the differences between management's goals and administrative complexity. For instance, the comprehensive plan requires a complete overhaul of the benefits package, and may be a far more complicated endeavor than establishing an account and adding new benefit options to the standard benefits package. The experiences of the surveyed companies that provide either a comprehensive cafeteria plan or a stand-alone flexible spending account are described below.

Comprehensive Cafeteria Plans

Hewitt Associates estimates that 75 major corporations offer dependent care as an option in their flexible benefits programs. The Employers Council on Flexible Compensation (ECFC) estimates that the number would increase to over 500 employers if medium-sized companies were included.

The core program in a flexible benefits plan typically consists of the following benefits:

- health insurance,
- life insurance,
- disability insurance,
- vacation,
- retirement income.

Less frequently, core benefits include tuition assistance and capital accumulations (savings and profit sharing). Procter & Gamble includes adoption assistance in its core package.

Optional benefits that are nontaxable by law, which may be purchased with flexible credits, include:

- dependent care,
- unreimbursed medical expenses,
- unreimbursed dental expenses,
- unreimbursed vision and hearing expenses,
- legal services,
- financial planning,
- deferred savings [i.e., 401(K)] plan.

The number of flexible credits almost always depends on an employer contribution plus a proportion of salary, qualified by length of service. Some formulas are more complicated than others. For instance, American Can's flex credits are computed as follows: $900 employer contribution + 1 percent of pay + $10 for each year of service. Procter & Gamble contributes between 2 and 4 percent of pay, based on length of service. Generally, the credits are received in separate payments

[7] Interview with Linda McFarland, Benefits Manager, Hewitt Associates, September 1984.

Requirements of Dependent Care Assistance Programs (DCAP)[1]

Employer Requirements

Written Plan: The employer must prepare a separate written plan for the DCAP. The program must be for the exclusive benefit of its employees in providing employees with dependent-care assistance.

Anti-Discrimination Rules: The program must not discriminate in favor of employees who are officers, owners, or highly compensated, or in favor of the dependents of these employees. Members of a collective-bargaining unit may be excluded if dependent-care benefits have been the subject of good faith bargaining between the employer and the union but were not included in the union contract. No more than 25 percent of the amount paid for dependent-care assistance may be paid on behalf of individuals who own more than 5 percent of the stock of the employer if it is a corporation or if they own more than 5 percent of the profits or capital interest in an unincorporated employer.

Notification: The employer must notify eligible employees of the availability and terms of the program.

Statement: The employer must give the employee a written statement showing the amounts paid or expenses incurred by the employer in providing dependent-care assistance. This statement must be received by January 31st following the year in which expenses were incurred.

Federal Taxes: The amounts paid under this program are excluded from consideration with respect to federal withholding, social security, and unemployment tax.

Funding the Program: The employer must either establish a fund or pay the costs as they arise.

Employee Requirements

Earned Income Requirements: No employee may exclude from income an amount larger than the amount earned during the year. Thus, for example, if a part-time employee earned $4,000 and received a child-care benefit of $5,000, the employee would have to pay tax on the $1,000 difference.

In the case of married employees, the excluded income can not exceed the earned income of the lesser earning spouse. For instance, an employee with a nonworking spouse does not qualify for the DCAP and will have to pay tax on the total value of a child-care benefit. However, a spouse who is a full-time student for at least five months during the year, or who is disabled, will be assumed to have earned $200 per month if there is one child, or $400 per month if there are two or more children. Consequently, a student or disabled spouse may accrue up to a maximum of $2,400 or $4,800 worth of excludable income and thereby qualify the employed spouse for the DCAP.

Relationship to Child Care Tax Credit: Subsidies or services received through a DCAP are not subject to the child-care tax credit. However, if an employer subsidized only part of an employee's dependent-care costs, the employee may take the child-care tax credit on the unsubsidized portion.

Provider Requirements

The caregiver may be any person except one for whom the employee or the spouse of the employee is permitted to take a personal exemption, or a person who is the employee's child under the age of 19. Thus, typically, the caregiver cannot be the employee's spouse or a teenage sibling of the cared-for children.

[1] Reprinted with permission from Kathleen A. Murray, Attorney at Law, Child Care Law Center, San Francisco, CA "Employer-Supported Child Care Receives a Boost: Dependent Care Assistance Programs," 1983. See Appendix A for sample DCAP.

or the amount is included in the employee's paycheck. The frequency of payments varies from bi-weekly to monthly to quarterly. At American Can, credits are generated each pay period based on the credit formula and are then portioned out according to the schedule selected by the employee on the flexible benefit enrollment form.

Eligibility

There are no salary limits placed on eligibility for flexible benefits. In fact, the purpose of flexible benefits is to provide *all* employees with a benefits package of comparable value. However, only salaried employees are included in the plan in several partially unionized companies, since benefits are negotiated separately for union members. For example, American Can is 36 percent unionized in its domestic operations, and only salaried employees in the headquarters and packaging plants are eligible for participation in the flexible plan. P & G is 25 percent unionized, and only monthly salaried employees and nonmanufacturing, weekly salaried employees receive a choice in benefits through the company plan. A separate plan containing essentially the same benefits has been established at a nonunion manufacturing location for hourly and weekly salaried employees.

Some employers require that employees must work for the company for a specified period of time before they are eligible to participate. One year of employment is required by Cleveland Clinic and, depending on the date of hire, P & G employees are not eligible for a period of 18 to 30 months. Among the six companies with flexible benefits responding to the survey, only ETS allows regular part-time employees to participate in the flexible plan and prorates credits according to the hours worked.

Most companies follow the requirements defined by Section 129 of the Internal Revenue Code with regard to the application of dependent-care benefits: Licensed centers, family day-care homes, and in-home babysitters are covered for the hours of child care needed in order to work. Dependent-care credits may also be used to care for elderly parents and disabled dependents. (See box, p. 8.)

Utilization

A relatively small proportion of employees take advantage

of dependent-care assistance in flexible benefit plans. Of the major corporations surveyed, the utilization rates ranged from 2 percent at ETS to 7 percent at Comerica. Dickinson College, with 465 employees of whom 40 percent are females, finds 6 percent of its employees selecting dependent care in their package of benefits in the first part of FY 85. This represents a marked decline in use since compliance with the forfeiture provision proposed in Section 125 regulations. Approximately 5 percent of the P & G population choose dependent care, but this figure represents 25 percent of eligible employees with children.

The distribution of use varies among companies as well. All but two of the responding companies report that the dependent care benefits are used equally among clerical and professional workers. Companies indicate that mothers appear to select the dependent-care benefit more often than fathers: Only P & G could document that a substantial portion of men select dependent care—50 percent of the users of dependent care were men, although two-thirds of flexible benefit program participants are men.

In most companies, employees are allowed to spend the total value of their flexible credits on child care. From the few companies responding to the survey, parents appear to spend from $700 to $3,000 of their credits per year when selecting the dependent-care option.

Flexible Benefits in the Public Sector

Only a handful of government agencies have implemented flexible benefit plans for their employees, yet interest is growing. Benefit plans in the public sector are typically rigid, offering less choice than private-sector employers. Public-sector plans are also highly contributory, and in some instances, due to expensive pension plans, may be more costly than those in the private sector. According to Robert Kalman of William Mercer-Meidinger, Inc., an employee benefits and compensation consulting firm, they are "ripe for development."

An administration official in the State of North Carolina further observed that: "State government is often the largest employer in the state. It is also likely to be a growth area for unionization. Pressure may increase for individualized benefits and, as a result, flexible benefits may become a bargaining item in a growing number of states—particularly those that hope to serve as a role model for private sector employers."

North Carolina's state government is contemplating provision of flexible benefits. Catawba County, North Carolina, has already implemented a flexible plan that includes a flexible spending account with a dependent-care option. Salary reduction is allowed up to 10 percent of pay. Annual reimbursement for child-care expenses is limited to $5,000.

Cost to the Company

Companies assume the costs for designing, implementing and administering a new flexible system. Ongoing, administrative costs for ETS and Cleveland Clinic were about $30,000 per year in 1983. According to Hewitt Associates, most of the major corporations with cafeteria plans provide some direct employer contribution to the flexible credit account. This amount ranges from $100 to $1,000 per employee and is typically $300. None of the employers specifically designates contributions for dependent-care expenses. With the exception of the legal fees required to prepare a Dependent Care Assistance Plan, employers do not incur any extra cost for including child care in a flexible plan.

Planning

A number of companies with the dependent-care option in their cafeteria plans have considered alternative ways to address the child-care issue. In such firms, the need for child-care assistance surfaced prior to, or independent of, the introduction of flexible benefits. To illustrate: ETS learned of staff interest in an on-site day-care center before it added dependent care to its flexible program. At Procter & Gamble, a human-resource manager was working with a consultant studying and designing child-care solutions independent of the decision to provide flexible benefits and establish a dependent-care option.

The majority of employers, however, learned about their employees' child-care needs while designing their flexible benefit plans. In surveys and focus groups designed to elicit employees' needs, child care would emerge as a preferred benefit option. Companies did not respond to this identified need until passage of the 1981 tax legislation, when dependent care was made a nontaxable benefit. Thus, ETS' cafeteria plan, begun in 1974, did not include dependent care until 1982; American Can had its plan in place four years before dependent care became an option.

Expectations

Most companies believe that they will be able to control or reduce benefit costs by offering choices through a cafeteria plan. They also hope to engender greater loyalty from employees who are more satisfied with their benefits.

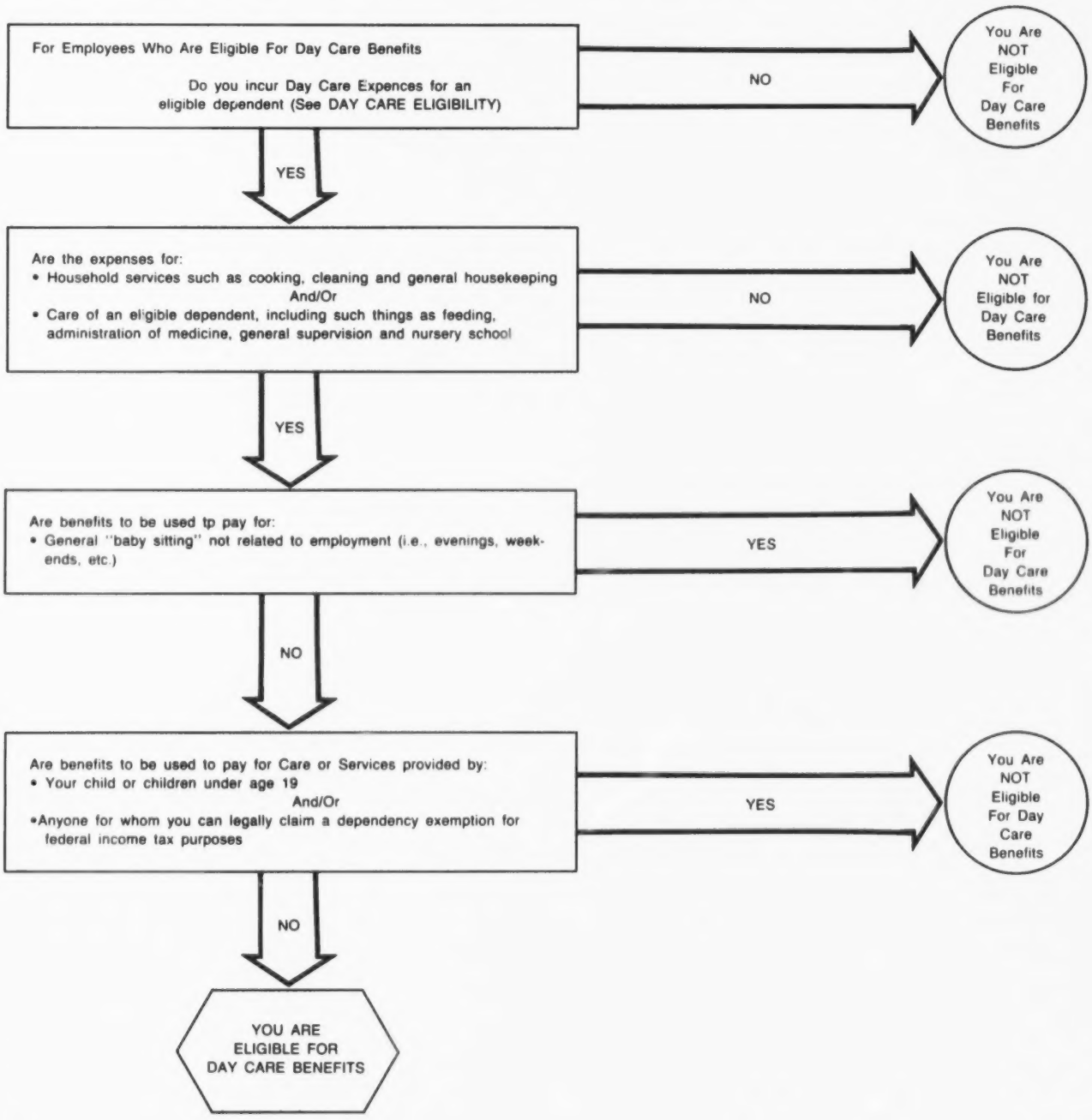
In a survey conducted by American Can in 1982, 74 percent of employees rated the benefit program "good" to "excellent," compared with a norm of 56 percent for other companies. In a separate study, Hewitt reports that three of ten employers that have completed a financial analysis of their flexible programs, found that flexibility reduced benefits costs; five indicated that flexibility contained benefit-cost increases; and two reported no cost savings.[8]

Employers surveyed for this report indicated that they expected additional returns from the inclusion of dependent-care assistance. Most employers predicted that their attention to child care would help them attract and retain employees, reduce stress, and increase productivity. No company had data to substantiate these claims, nor were any planning to collect such data in the future.

[8] Hewitt Associates, *On Flexible Compensation*. New York: July 1983, p. 4.

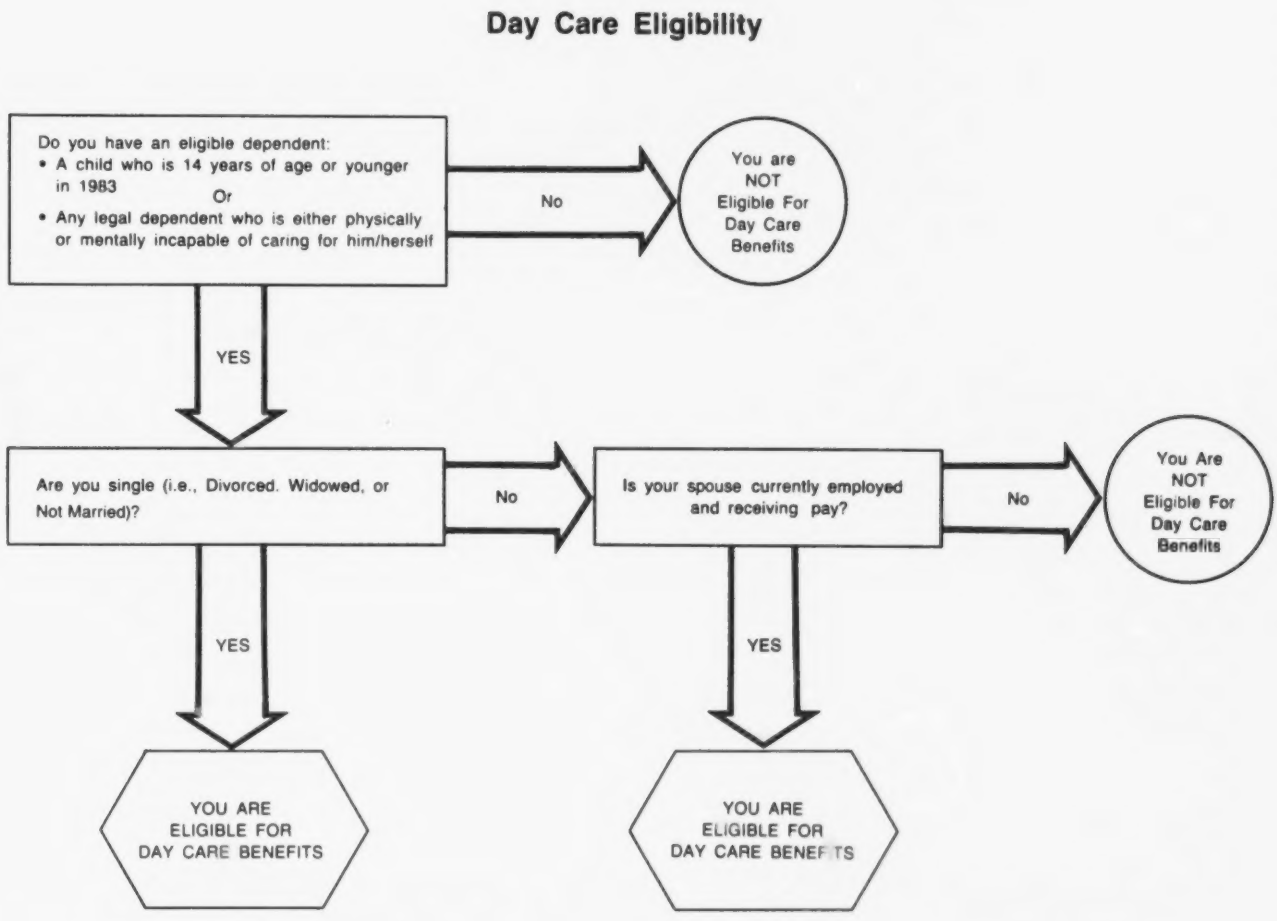
Chart 1: Eligible Expenses

Eligible "Employment Related Expenses"


For Employees Who Are Eligible For Day Care Benefits
Do you incur Day Care Expences for an eligible dependent (See DAY CARE ELIGIBILITY)
NO
You Are NOT Eligible For Day Care Benefits
YES
Are the expenses for:
• Household services such as cooking, cleaning and general housekeeping
And/Or
• Care of an eligible dependent, including such things as feeding, administration of medicine, general supervision and nursery school
NO
You Are NOT Eligible for Day Care Benefits
YES
Are benefits to be used tp pay for:
• General "baby sitting" not related to employment (i.e., evenings, weekends, etc.)
YES
You Are NOT Eligible For Day Care Benefits
NO
Are benefits to be used to pay for Care or Services provided by:
• Your child or children under age 19
And/Or
•Anyone for whom you can legally claim a dependency exemption for federal income tax purposes
YES
You Are NOT Eligible For Day Care Benefits
NO
YOU ARE ELIGIBLE FOR DAY CARE BENEFITS

Source: American Can Company

Chart 2: Day Care Eligibility


Day Care Eligibility
Do you have an eligible dependent:
• A child who is 14 years of age or younger in 1983
Or
• Any legal dependent who is either physically or mentally incapable of caring for him/herself
No
You are NOT Eligible For Day Care Benefits
YES
Are you single (i.e., Divorced. Widowed, or Not Married)?
No
Is your spouse currently employed and receiving pay?
No
You Are NOT Eligible For Day Care Benefits
YES
YES
YOU ARE ELIGIBLE FOR DAY CARE BENEFITS
YOU ARE ELIGIBLE FOR DAY CARE BENEFITS

Source: American Can Company

Two Company Experiences

Dependent care as part of a comprehensive cafeteria plan is illustrated by two companies with different lengths of experience: One has recently instituted its plan; the other is considered one of the pioneers in the flexible benefits field.

Procter & Gamble. The Procter & Gamble Company has 10,000 of its 17,000 management and nonplant, weekly salaried employees headquartered in Cincinnati, Ohio. Approximately 30 percent of this headquarters work force is female. Management observed the increase in the number of workers belonging to dual-earner families. A limited flexible benefits program including only IRA and cash was implemented for the salaried employees of the company in 1982. In 1983, the flexible benefits program was expanded to include several nontaxable benefits as well. Concurrently, a Child and Dependent Care program was established, to which company contributions not used for flexible benefits could be directed. At the time, the provisions of Internal Revenue Code Section 129 were understood to require that dependent care could only be provided under a separate plan.[9] As a result of the proposed IRS regulations for Section 125 of the Code, dependent care will be included in the P & G flexible benefits program in 1985.

The company contributes 2 to 4 percent of an employee's pay which can be applied to optional benefits including vacation, cash, dependent care, unreimbursed vision and dental expenses, and up to $400 in life insurance premiums. Approximately 5 percent of employees apply their credits to dependent care, accounting for 3 percent of total credits used. A benefits officer explained that while the 5 percent utiliza-

[9] Unlike other statutory provisions governing employee benefits, Internal Revenue Code Section 129 authorizing dependent care requires a separate written plan—but reimbursement *can* be made along with other benefits.

Table 7: Features of Cafeteria Plans

	Educational Testing Service	*American Can*	*Procter & Gamble*	*Comerica*	*Cleveland Clinic*	*Dickinson College*
Core Benefits	Health, life, disability, vacation, retirement, holidays, personal time, tuition assistance, educational allowance	Health, life, disability, vacation, retirement, adoption	Health, life, disability, retirement, capital accumulation, tuition, adoption assistance, profit sharing	Health, life, disability, vacation	Health, life, short-term disability, paid time off, retirement, tuition assistance	Health, life, disability, vacation, retirement
Source of Flexible Credits	3 to 6% of salary based on years of service	$900 + 1% pay + ($10 × years of service)	2 to 4% of pay based on years of service	Age, seniority, pay	Percent of pay from employer, trade-in paid time off	5% salary + 5% college contribution + cost of employer share in insurance, $2,000 salary for health
Optional Benefits	DCAP, retirement, medical, life, dental, vacation, mutual funds, physical exam, dependents' life insurance, cash	DCAP, medical, dental, life, disability, capital accumulation, vision, hearing, preventive health, financial planning	DCAP, vision/dental, life, vacation, cash. Cash may be used for dependent life, financial planning	DCAP, medical, life, disability, vacation, capital accumulation, AD&D, dependents' life, health care, cash	DCAP, dental, life, long-term disability, tuition, vision, prescription drugs	DCAP, retirement, medical, dental, life, capital accumulation, vacation, legal
Method of Distribution	Separate payment to employee or provider, semi-monthly or as bills are submitted	Employees' accounts in the options they elected on regular paydays	Separate payment, quarterly of vision/dental reimbursements to provider or employee (semi-annual)	In the paycheck, bi-weekly	Separate payment as bills are submitted	Separate payment, monthly
Utilization of DCAP	2%	1%	5%	7%	1.5%	6%
Yearly per Employee Cost of DCAP	$3,000	$700	$500	$1,800	N.A.	N.A.
Cost to the Company for DCAP, Yearly	$30,000	$26,000	$400,000	Administrative expense only	N.A.	Administrative expense only
Total Number of Company Employees	2,300	26,000	45,000	6,000	7,500	465

N.A. = no answer.

tion appears low, it actually represents about 25 percent of eligible parents in the P & G salaried work force. Most of these parents are younger, shorter-service employees.

Unconnected to the planning and provisions of dependent care in a flexible plan, a consultant was hired to analyze employees' child-care needs and the community resources to meet them. A three-pronged strategy was proposed, and was accepted by management in 1983.

The first recommendation suggested that P & G provide seed money and technical assistance for the creation of a child-care resource and referral service housed within the Cincinnati Community Coordinated Child Care Agency. This program began in the Summer of 1984. The second idea addresses the needs of parents with school-age children. Efforts are under way to improve the quality and quantity of these services. Finally, the third recommendation led the company to provide start-up funds for two day-care centers in which P & G employees will have priority in 75 percent of the spaces. One center opened in the Fall of 1984, the other began serving families in January, 1985. The job of Manager, Child Care Services, was

created to coordinate these various child-care initiatives over a two-year period.

These community-related initiatives, however, are separate from the company's provision of dependent care within the flexible benefits program. A benefits officer explained that the benefit strategy was not designed to solve the multitude of problems related to child care. "We were simply trying to help parents through advantages provided in the tax code. We demonstrated our interest in child care with a very quick response. The other child-care services required a lot of planning and involved the creation of new resources—resources that help our employees use the dollars we make available through our flexible plan." Among the programs in the study, P & G represents one of the most comprehensive corporate responses to child care in the country.

Educational Testing Service (ETS). ETS was one of the pioneers in the flexible benefits movement. It restructured its benefits package in 1974, and has continued adding new benefits as employee needs are identified. Dependent care, for instance, was added to the flexible benefits plan in 1981, after an investigation into other child-care alternatives and a change in the tax laws.

The core of the ETS flexible benefits package consists of health insurance, life insurance, temporary and total disability insurance, paid vacation, a retirement-income plan, personal time off, tuition aid, and an educational allowance. Flexible credits are company funded, and employees receive 3 to 6 percent of base salary, based on years of service. Credits may be applied to the following optional benefits: dependent care, retirement, medical coverage for dependents, dental coverage, life insurance (for employees and dependents), four major mutual fund companies and cash. Employees must incur expenses before the semi-monthly reimbursement is made for dependent care. All 2300 ETS employees, working in eight locations around the country, are eligible to participate. Regular staff working part-time are included in the program, although their flexible credits are prorated on the basis of the hours worked.

While the new system came into effect in the early 1970's as a way to control benefit costs and recruit a talented work force, child-care issues emerged from another area of concern. In 1980, a women's committee recommended that a day-care center be established at the headquarters office. An employee survey was conducted indicating an interest in a center, but the beneifts department eventually rejected the idea. It was concerned about the initial start-up costs (which were estimated at $500,000), low utilization, liability risks, and employees taking too much time away from work to be with their children during the day. As the center proposal was being rejected, Congress had just passed the Economic Recovery Tax Act, which made child care a nontaxable benefit. The benefits department concluded that employees would utilize child-care reimbursements included as an option in the flexible benefits plan.

The 1980 survey of child-care needs indicated that 300 employees might use an on-site center. However, ETS has found only 48 employees, or approximately 2 percent of the work force, electing dependent-care coverage in the flexible benefits plan. (Fewer than five of these employees apply dependent-care credits to the care of their elderly parents.) ETS attributes low utilization of the dependent-care option to preference for other attractive benefit options.

ETS estimates the cost of dependent care to be $250 per month per employee. In 1984, approximately $31,000 was contributed by ETS to its employees' dependent-care costs.

In an effort to increase the supply of child care in the community, ETS made a two-year, start-up grant to a local infant-care center. ETS employees may apply their flexible credits to the purchase of these services and, in addition, receive a discount on their fees. Approximately 12 to 15 ETS employees have enrolled their infants in this program. ETS considers inclusion of dependent care in its flexible benefit plan to be its primary response to the child-care problem. Some changes are planned given the proposed IRS regulations—such as no more cash-outs and no vacation carryovers—but the dependent care option remains stable and secure.

The Flexible Spending Account and Salary Reduction

A flexible spending account (FSA) is a reservoir of funds upon which employees may draw to cover the costs of benefit options not included in the regular benefits package. Many employers create FSA's in order to avoid the complexity and administrative costs characteristic of broader cafeteria plans. An additional appeal of the FSA is that it can be funded through employee salary reduction—at no cost to the employer. The list of benefits to which funds from the FSA can be applied is identical to the optional benefits included in a cafeteria plan (page 21).

The Employer Council on Flexible Compensation estimates that between 300 and 500 companies have set up flexible spending accounts. When municipalities, nonprofit organizations, small retailers, and professional firms (accountants, lawyers and architects) are added, as many as 1,000 FSA's may be in existence at the time of this writing. With final regulations on Section 125 yet to be issued, and tax reform proposals pending, the future of FSA's is uncertain.

Funding FSA's

Many FSA's are funded with employer contributions. For example, Chemical Bank contributes $300 to each employee's account. Hewitt Associates puts in $360 to $1,560 per employee, depending on years of service. Another source of funding for the FSA is profit-sharing and savings accounts. Mellon Bank and Chemical Bank allow employees to allocate up to 50 percent of profit-sharing funds to the spending account.

Nearly all employers with FSA's, however, implement a program of salary reduction. Under the law, the amount of salary reduced is treated as employer-provided amounts. This enables an employee to use pre-tax dollars for needed benefits and services. In addition, the employer can add new benefits without incurring additional benefit costs. In fact, employers

may save money because they do not pay social-security or federal unemployment-insurance taxes on the amount of salary reduced.

While the practice can be of significant financial assistance to employees, the term "salary reduction" is threatening. This has led to a variety of titles. Chemical Bank's program is called "Salary Redirection"; Pepsico's is a "Choice Pay Reserve Account"; and Toro Company's child-care financing is called a Dependent Care Expense Account.

The savings for employees can be considerable. If, for instance, an employee earns $50,000 and has $3,000 in child-care expenses, the employee can pay income taxes based on a $47,000 salary and spend the $3,000 needed for child care out of pre-tax dollars. Table 8 shows the tax savings to a married employee with an adjusted gross income of $50,000, and who elects a salary reduction of $3,000 to cover dependent-care expenses. (See also Appendix B.)

Many employers put a cap on the amount of salary that can be reduced. Employers choose to do this in an effort to meet the nondiscrimination tests defined by Sections 129 and 125 of the Internal Revenue Code. This ceiling is often set at $5,000 per employee. The total amount available for dependent care may be greater if employer dollars or a portion of profit-sharing accounts are contributed to the employee account. Some employers, such as Pepsico, have a $5,000 cap for reimbursed medical expenses and a separate cap for dependent care. Toro Company has a cap of $2,400 for health-care costs and $4,800 for child care. General Foods allows $1,800 to be spent on health care and $5,800 for dependent care. The separate accounts eliminate the possibility that an employee will have to make a choice between quality health care and quality child care.

Table 8: Expenses, Taxes and Salary Reduction: An Example

	Without Salary Reduction	*With Salary Reduction*
Salary	$50,000	$50,000
Salary Reduction		3,000
Income	50,000	47,000
Taxes		
Federal (Joint Return)	10,238	9,186
FICA (Employee's Share)	3,350	3,149
Total	13,588	12,335
After-tax Income	36,412	34,665
Dependent-care expenses	3,000	0
Dependent Care Tax Credit	600	0
Net Income After Expenses	34,012	34,665
Savings		653

These estimates are based on 1984 tax figures, assuming three personal exemptions and no deductions, additional income, adjustments to income or other tax credits.

The funds from the account are either included in the employee's regular paycheck or are made available as a separate payment on a bi-weekly, monthly or quarterly basis. The frequency of distribution to Pepsico employees varies depending on the amount to be reimbursed. At Toro Company, reimbursement differs for hourly workers and salaried office workers.

Utilization

The proportion of employees taking advantage of salary reduction for dependent care is relatively low. This cannot be explained with any consistency by the surveyed companies. The highest rate of use was reported by a thirty-eight-person law firm at which all five of the employees with dependent-care expenses made use of the firm's new policy. Among 154,000 employees at Pepsico, an estimated 6 percent pay for dependent care with pre-tax dollars. More than 300 of the 8,000 employees at The St. Paul Companies have their salaries redirected for dependent-care purposes. A much smaller proportion of Mellon Bank employees (2 percent of 6,800 employees) have taken advantage of dependent-care financing.

Hospitals, with a greater number of female employees, may find higher utilization of the dependent-care option. For instance, Good Samaritan Hospital and Medical Center in Portland, Oregon, figures that, for the period of January through June, 1984, 71 percent of the $457,000 deposited in employees' flexible spending accounts was allocated to dependent-care expenses.[10]

While all companies follow the guidelines of Section 129 that permit expenditures on care for children, elderly parents, or disabled dependents, none has differentiated the type of dependent-care purchased. However, in company interviews, managers felt that most reimbursements from flexible spending accounts were applied to child-care expenses.

Nor have companies collected information on the distribution of use among employee groups. Most companies indicated in interviews that use of dependent-care assistance was equally distributed across income groups, but that mothers took advantage of the benefit more often than fathers. Broad distribution among income groups is desirable in order for companies to meet the IRS-proposed nondiscrimination test (highly compensated employees cannot receive the greatest share of the benefits). The potential for discrimination is highest when salary reduction is the mechanism used for funding FSA's, because lower-income employees may fare better when taking advantage of the child-care tax credit. (See Appendix B.)

J.C. Penney and Morgan Guaranty Trust Company provide guidance to their employees in determining the degree to which the tax credit, salary reduction—or some combination of the two—would be most advantageous. The National Women's Law Center estimates that the adjusted gross income levels at and below which the dependent-care credit is at least as advantageous as salary reduction for dependent-care expenses are $26,000 (for married taxpayers filing jointly),

[10] *EBPR Research Reports*, Charles D. Spencer & Associates, Inc, 222 West Adams Street, Chicago, IL 60606, pp. 13-14 (8-84).

$22,000 (for heads of household), and $19,200 (for single taxpayers) under 1984 tax rates. While the tax credit may yield more money for lower-income parents in the long run, some may prefer salary reduction because they can receive reimbursement as services are purchased, rather than at the end of the tax year.[11]

Recognizing the advantages of salary reduction for higher-wage earners, the imposition of a cap on the amount of salary that can be reduced may help reduce the likelihood of discrimination. For instance, a cap of $5,000 would prevent a $75,000-a-year employee from receiving $12,000 in tax-free dollars to pay for an in-home housekeeper.

Planning

Most of the employers responding to this study identified child-care needs through surveys of employees conducted while the FSA was in the planning stages. A spokesman for Toro Company explained: "In investigating the health-care expense account, we looked at other pre-tax alternatives and discovered dependent care." Only Chemical Bank and The St. Paul Companies, among the respondents, indicated that a range of child-care initiatives had been investigated prior to adoption of the FSA. In the smaller firms, the impetus for inclusion of dependent care emerged from the experience of a decision maker who had child-care expenses and understood the burden they impose.

Two Company Experiences

Flexible spending accounts have become popular with banks, although the design of their plans vary considerably. The following examples describe two bank experiences with spending accounts and dependent care.

Mellon Bank: In an employee survey conducted in 1980, Mellon Bank (Pittsburgh, Pennsylvania) learned that 48 percent of its employees believed that the Bank's benefits were not as good as those provided by its competitors. A comparative study of benefits confirmed the employees' perceptions. The primary reason for the dissatisfaction with Mellon's benefits was that they were heavily weighted toward retirement and profit sharing—benefits that are not as useful to their 60-percent female population as to the male work force. Management decided that flexible benefits and salary reduction might address this problem. On April 1, 1983, the salary redirection program was implemented for Mellon's 6,800 employees. In a 1984 survey of employees, it was found that 77 percent felt that the benefits provided by Mellon Bank were as good as—or better than—those provided by its competitors.

Chemical Bank in New York was unwilling to adopt the comprehensive cafeteria plan because of its administrative complexity. However, the Bank was concerned about the rising cost of benefits and the changing demographics of its work force.

[11] A complete explanation of calculations by the National Women's Law Center appears in Appendix B, and was specially prepared for this report by Sally Goldfarb.

The investigation into alternative approaches in benefits delivery eventually led to the creation of an employee spending account and salary redirection program. As part of its 1981 review of benefits, Chemical Bank had a third party conduct interviews and a demographic study. Although Chemical Bank spent approximately $120 million on benefits in 1983, the investigation revealed that it was not meeting the needs of a majority of its employees. It was discovered that fewer than 13 percent of the Bank's 18,659 employees fit the traditional, male-breadwinner profile. Rather, 59 percent of Chemical Bank's employees are women, and this figure is expected to rise to 67 percent by 1987. Furthermore, 50 percent of the workers are single.

The following goals were established for the redesign of benefits to address the issues of cost and demography.

(1) Benefit costs should be comparable to those in other New York City banks.

(2) Benefit strategies should establish Chemical in a leadership position as an organization responsive to employee needs.

(3) The redesign plan should make employees feel more secure, for example, by rewarding longer service.

(4) The plan should be tax-effective and flexible for the company—taking into account the bank's shifting demographic, economic and legal environment.

(5) The plan should be simple enough for its value to be recognized.[12]

Chemical Bank's Employee Spending Account (ESA) appeared to satisfy these goals. The Bank deposits $300 into the ESA's, and employees eligible for profit sharing can add up to 50 percent of their annual profit-sharing payments to this sum. (In 1983, 64 percent of eligible participants contributed to ESA's.)

Under the Economic Recovery Tax Act, the overall reimbursement limit for employer contributions is $800 per year. This was the maximum amount that could be spent on all optional benefits until September, 1983, when the Salary Redirection Program was introduced. Under this program, employees could redirect up to $2,000 per year of their salaries to their pre-tax accounts. In 1984, a $5,000 limit was set on salary redirection. Including the employer contribution and profit-sharing diversion, employees can spend a maximum of $5,800 on the following benefits: dependent care, medical deductibles and co-insurance, dental insurance premiums, legal fees, and expenses for medical and dental services not covered by insurance. Employees are reimbursed from their accounts on a quarterly basis.

In 1983, there were 20,000 claims for reimbursement from ESA's. An estimated 1.3 percent of these claims were for dependent care. Approximately 6 percent of reimbursement dollars were for dependent care; 90 percent of the dependents needing care were children. These employees received $267,061

[12] Donald C. Platten, "The Employee Benefits—Does the Company Also?" *Harvard Business Review*, September-October, 1983, p. 20-21. See also "Chemical Bank's 'Employee Spending Account'," *Benefits News Analysis*, February 1983, Vol. 5, No. 2, pp. 4-8.

An Assessment of Flexible Benefits and Inclusion of a Dependent Care Option

(Based on the experiences of identified companies)

General Advantages of Flexible Benefits Plans

- An equitable response to diversity.
- Control or reduction of benefit costs. Flexible benefits help break the pattern of "more," by establishing a limit on value of the total benefits package.
- Employee awareness of benefits and their cost. Employees must be educated about all benefits before making choices. They may come to appreciate the employer's benefit expenditures.
- Particularly useful when creating a unified package of benefits following a merger or acquisition because of the need to blend two different benefit packages.

Specific Advantages for a Child Care Option

- Reduces inequities of responding to the needs of parents by satisfying other employees' needs.
- Low cost, since the cost of child care can be shared by the employee.
- Offers flexibility so that the program can adapt to fluctuations in employee needs.

Disadvantages of Flexible Benefits Plans

Potentially high implementation costs are incurred as communication and computerization needs are met.

- Adverse selection—the probability that employees with a greater chance of incurring the risk may select the option, while those with a lesser chance will choose other benefits. Since group insurance rates are based on an even distribution of risk, the costs of insured programs in a cafeteria plan may fluctuate because the covered group will represent the poor risks. Insurance companies estimate that adverse selection might account for a 3-5 percent increase in benefit costs.
- Tax law uncertainties due to the lack of final regulations on IRC Section 125 and impending debates on tax reform.

Specific Disadvantages for a Child Care Option

- The child-care option may not be sufficient if there is inadequate child care to be purchased in the community.
- May force parents to choose between needed health-care and child-care benefits.
- Lower-paid employees may benefit more from the Dependent Care Tax Credit.
- Possible discrimination if the demographics of the work force are such that parents are disproportionately found among upper-income employees. The plan would be invalid if the company cannot meet the nondiscrimination test.

in pre-tax dollars to spend on dependent care. In 1984, dependent care accounted for nearly 2 percent of all claims and 8.7 percent of reimbursement dollars. Employees received $584,053 in dependent care assistance.

Chemical Bank's interest in finding a solution to child-care problems surfaced before the implementation of the spending account. Employee inquiries and responses to attitude surveys sparked some interest; media influence and suggestions from women's organizations heightened the pressure. An on-site center was considered, but there was concern about equity and location—Chemical has local branches and offices at 270 locations in the New York State area alone. Adoption of Section 129 of the Internal Revenue Code prompted management to include child care in a reimbursement program.

There are no plans for future child-care initiatives. One reason cited by management for the lack of an additional response was that few employees speak up about their child-care problems—particularly professional women who are in management positions. The Bank is investigating its options with regard to compliance with proposed IRS regulations.

Changes Proposed by the IRS

In early 1984, an accountant in Milwaukee had his taxes audited and questions were raised about the taxability of services purchased through his employer's zero-balance reimbursement account—or ZEBRA. Under a ZEBRA plan, employees could be reimbursed for reported child-care expenses, for instance, while their paychecks were reduced by the amount paid as reimbursement. The employee did not pay taxes on that part of the salary used for child care.

The IRS challenged ZEBRA plans, as well as other forms of flexible compensation, in its Information Release (IR 84-22) of February 10, 1984, which stated that such arrangements are "without substance and do not reduce employees' taxable income." The IRS had waited five years to propose regulations to Section 125 while refusing hundreds of individual requests from companies to review their plans and issue a private-letter ruling that would approve the plans. Further, the IRS now proposed retroactive tax penalties on employees and employers. Ambiguity in the release further worried companies and advocates of such plans, because it looked as though all forms of flexible spending accounts—and not just ZEBRA's—were illegal. A spokesperson for The Wyatt Company, a benefits consulting firm, was quoted as saying:

> **"The IRS position would retroactively penalize hundreds of companies and millions of employees who have acted in good faith, destroy a major private-sector initiative to involve employees in health-care cost containment, effectively eliminate company-provided child-care benefits for working mothers, and have a chilling effect on legitimate cafeteria benefit plans that promote employee choice."[13]**

On May 7, 1984, the IRS published proposed regulations clarifying and modifying some of the positions made in its February statement. Dissatisfied with that proposal, the business community pressured Congress to respond to the IRS ruling. Legislative proposals made by Representative Barber Conable and Senator Robert Packwood were not voted on,

[13] "IRS Upsets Practitioners with Flexible Benefits Announcement," *Daily Report for Executives*. Washington, DC: Bureau of National Affairs, February 23, 1984, p. K-4.

but a provision in the Deficit Reduction Act of 1984 allowed flexible spending accounts in existence or being implemented on February 10, 1984 to continue, and provided for relief from retroactive tax penalties until January 1, 1985. Special relief is provided through July 1, 1985 for certain provisions of the proposed regulations. To qualify for this extended grace period, plans must require employees to determine their contribution amount before the plan year starts and no cashout of unused funds is available before the end of the grace period, plan year.

The IRS held hearings on its proposed regulations on July 26, 1984, that were followed by a more general discussion of the taxability of benefits in hearings before the Senate Finance Committee. The date for issuance of final regulations by the IRS is uncertain, but companies with flexible plans are to comply with the provisions outlined in the proposed rules made in May and the Transitional Rules proposed on December 31, 1984.

While elements of the proposed rules remain controversial, the structure of flexible plans has been defined. It is clear, for instance, that "ZEBRA plans are dead," as one consultant proclaimed. Salary reduction plans are permitted and the proposed regulations require that employees make an irrevocable selection of benefits, once a year, and amounts be elected *before* expenses are incurred by the employee. Benefit elections may be revoked during the year due to a change in status such as marriage, divorce, death of a spouse or child, birth or adoption of a child, and termination of employment.

It has been recommended by some that in order to anticipate child-care expenses properly, other allowable changes in status should include a move from part-time to full-time work, family illness, and a change of child-care providers. To illustrate: If a parent switches from a family day-care home to a day-care center, costs might double. The unanticipated extra costs cannot now be covered under the flexible benefit plan.

Another requirement of the proposed regulations is the forfeiture of unused funds. After the grace period for pre-existing plans which ends June 30, 1985, if the employee does not use all funds set aside at the beginning of the plan year for dependent care, or any other benefit, then the employee loses them. Prior to this requirement, most employers provided unused funds as taxable cash or allow employees to carry them over into the next year's account. The primary purpose of the forfeiture provision is to preserve "risk sharing," a cornerstone of tax treatment for group insurance benefits. The IRS further intended to limit the amount of money put into spending accounts—since they ultimately lead to a reduction in revenues for the federal treasury.

The effects of the forfeiture provision may be significant. The majority of employers have instituted flexible spending accounts primarily for the purpose of controlling health-care costs. Employees using flexible spending accounts had a built-in incentive to spend medical dollars wisely because unused funds were refunded. However, because medical expenses are not predictable, an employee might discover at year's end that only $2,000 of the $3,000 set aside for health care has been spent. As one benefits specialist surmised: "Such people might run to the nearest health spa to use the rest of the allocation." The forfeiture provision thus renders FSA's ineffective in controlling health-care costs because they are unpredictable. On the other hand, employees may deliberately underestimate health expenditures—especially workers earning low salaries, who are least able to risk forfeiture. This group of employees will choose taxable cash instead of benefits, and will be unable to reap the intended advantages of using pre-tax dollars to acquire needed services.

Most benefit planners believe that the "use-it-or-lose-it" feature now required in flexible spending accounts will curtail their use for medical-care expenses. Furthermore, some companies may hesitate to implement flexible accounts because of their potentially negative impact on employee relations when unused funds revert to the employer. Dependent care, as a more predictable expense than health care, may become the sole benefit offered through flexible accounts. But, one benefits expert predicts, its growth will be inhibited because "it will no longer be dragged along by the proliferation of medical reimbursement accounts."

Another regulatory issue that may negatively affect the growth of dependent-care assistance provided through flexible spending accounts is the nondiscrimination test. It may be that the test will cover both the availability of benefits and their use. As proposed, a Section 125 plan must not discriminate in favor of highly compensated employees (with "highly compensated" defined as someone who is an officer, or a shareholder owning more than 5 percent of the voting power or value of the stock). A plan is also considered discriminatory if key employees receive over 25 percent of the aggregate value of nontaxable benefits provided to all employees (with "key employees" defined as officers of the company earning more than $45,000 a year). In addition, the nondiscrimination test requirements of Section 129 must be satisfied, although provisions seem to complement those required by Section 125. According to benefit consultants, it is likely that the nondiscrimination test will be similar to the test applied to pension planning where the top one-third of earners receive amounts in proportion to the bottom two-thirds of earners. If, for instance, the average compensation of the lower two-thirds of employees is $20,000 and there is a $1,000 limit on the amount that salary can be reduced, then the top-earning one-third, whose average compensation is $40,000, may be limited to $2,000 of salary reduction—both groups receiving 5 percent of salary in pre-tax dollars.

The nondiscrimination test, if based on utilization, raises some problems for inclusion of dependent care in some work forces. Younger, lower-paid workers may be less likely to have children or elderly parents than somewhat older, more highly paid workers. Furthermore, lower-paid workers may gain more from the dependent-care tax credit than from salary reduction. (See Appendix B). While the employer has made the benefit plan available to all employees, it may find that only the highly-compensated use it. If the nondiscrimination test is based on utilization, some plans may not satisfy it.[14]

[14] Comments submitted by the National Women's Law Center to the Commission of Internal Revenue on Tax Treatment of Cafeteria Plans, July 6, 1984.

Table 9: Features of Flexible Spending Accounts (FSA)

	Chemical Bank	*Pepsico*	*Mellon Bank*	*Toro Company*	*St. Paul Companies*	*Slade and Pellman*
Name of Program	Salary Redirection	Choice Pay Reserve Account	Salary Redirection	Health Care Expense Account; Dependent Care Expense Account	Reserve Account	Dependent Care Assistance Plan
Benefit Choices	DCAP, medical, dental, HMO premium, legal, accident premium	DCAP, medical, dental, vision/ hearing	DCAP, medical, dental, vision/ hearing	DCAP, medical, dental, vision/ hearing	DCAP, medical, dental, vision/ hearing, legal	DCAP
Method of Funding Account	Salary reduction, employer contribution ($300), profit sharing	Salary reduction, trade-off with other benefits	Salary reduction, employer contribution, profit sharing	Salary reduction	Salary reduction	Salary reduction
Limit on Salary Reduction	$5,800	$5,000—DCAP $5,000—unreimbursed health	$6,000—DCAP $1,800—unreimbursed health	$4,800—DCAP $2,400—medical/ dental	$3,500	N.A.
Method of Distribution	In paycheck quarterly	Separate payment Monthly if $200; Quarterly if $200	Separate payment Monthly as requested	In paycheck on regular paydays for hourly workers; monthly payment to salaried office workers	Separate payment biweekly	In paycheck on regular paydays
Utilization of DCAP	8.77%[1]	6%	2%	N.A.	4%	15%
Number of Employees	N.A.	154,000	6,800	2,200	8,000	38

[1] Chemical Bank's estimate for the utilization of dependent-care benefits is based on the percent of claims. All other company estimates are based on the percent of employees who claim the credit.

N.A. = no answer

To prevent the disproportionate use of benefits by "highly compensated" employees, some have suggested that a cap be imposed on the amount reimbursed under a flexible plan. Many benefit-consulting firms recommend a cap of $5,000 to assure nondiscrimination in the plans. Both Representative Conable and Senator Packwood included caps—a separate one for dependent care—in their proposed legislation. The Conable bill suggested that a cap be integrated with the Dependent Care Tax Credit. If, for example, an employee claimed $2,400 in dependent-care expenses under salary reduction, under the Conable bill, that person could not claim any expenses toward the tax credit, since $2,400 is the maximum limit on the credit for one dependent. Senator Packwood proposed a higher cap of $3,000 for dependent care. The IRS has not proposed any cap.

At the time these data were being gathered and analyzed, the range of tax-simplification and tax-reform proposals was not yet evident. It was, however, becoming apparent that interest in these issues was emerging. Not unexpectedly, proponents of financial assistance for child care through tax credits and nontaxable benefits felt that these approaches (singly or in combination) merited continuation. To them, the need for affordable child care is apparent, given the changing work force and the inadequate supply of care.

Other Financing Alternatives

The child-care assistance programs selected for detailed study were those that focused primarily on the affordability of child care for employees. Several corporations have developed other ways to help working parents pay for child care, but these efforts may be part of another initiative, such as the funding of an on-site day-care center; others may provide financial assistance to the community-at-large through corporate contributions. In addition, employee groups and unions have the opportunity to create a fund—called the Voluntary Employee Beneficiary Association (VEBA)—through which employees

can be helped to cover child-care expenses. Some employers focus their efforts on lobbying the Federal Government to help improve the child-care system and expand the child-care tax credit. These alternatives are described briefly below.

Subsidizing On-Site Day Care

According to the Work and Family Information Center, approximately 120 corporations and 400 hospitals currently sponsor day-care centers on or near the workplace. Nearly all of these employers provide the necessary start-up costs and most offer in-kind contributions that may lower the fees to the parents. Some of these employers also subsidize fees at the centers. According to a 1982 study conducted by the federally funded National Employer Supported Child Care Project, 84 employers offer a subsidy to help employees pay tuition fees in 211 on-site day-care centers. Fee assistance may assure greater utilization and prevent the center from becoming a discriminatory benefit. When fees are set at prevailing market rates, low-income employees may be prevented from using the on-site program. At Intermedics in Freeport, Texas, employees using the 289-child center pay only 40 percent of the cost of the $1-million budget of the center.

Campbell Soup Company, with a center run by Kinder-Care, subsidizes approximately 50 percent of its employees' cost of care. Hospitals, desperate for night-shift nurses, may make on-site centers available free of charge only to this group of employees. The costs of starting and subsidizing an on-site center may be high when the per employee cost of the benefit is considered. The level of financing commitment will depend on the nature of the child-care problems facing employees, and the company's motive for funding the center.

Corporate Contributions

An employer who approaches the child-care issue as a matter of corporate social responsibility may provide a financing solution that is not limited to its own employees. For example, since 1981, John Hancock Mutual Life Insurance Company in Boston has been making an annual donation of $50,000 earmarked for child care to the United Way of Massachusetts Bay. In addition, John Hancock has been donating $25,000 to two nonprofit day-care centers located near the company's headquarters. This money has been used to subsidize scholarships for children of low-income families in the community.

The Corporate Child Development Fund for Texas provides a convenient mechanism for employers to channel corporate contributions into child-care programs in communities in which the companies have plant sites. The Fund has received grants ranging from $500 to $10,000 from more than 40 corporations. Money is raised from urban-based employers and the Fund then makes grants to child-care programs in rural communities where there are not many large employers. While the employees of contributing companies are not guaranteed enrollment in these rural programs, they are encouraged to take advantage of the opportunities provided by these grants.

Voluntary Employees' Beneficiary Association (VEBA)

The purpose of the VEBA [organized pursuant to Internal Revenue Code Section 501(C) (9)] is to provide for the payment of life, sickness and accident insurance or other benefits to employees and their dependents.

VEBA's may be used to offer grants to child-care centers where employees' children are served and where employees have financial responsibility for the child-care program. The number of nonemployees who may be served by the child-care facility may not exceed 10 percent of the total enrollment in the program. The Hyman Blumberg Child Day Care Center, sponsored by the Amalgamated Clothing and Textile Workers Union, was organized through a VEBA in 1968.

Lobbying

Lobbying Congress for increased child-care support requires a commitment of time and political clout, rather than of cash. Due to cutbacks in welfare programs, a number of low-income employees became ineligible for federal subsidies for child care provided under Titles XX and IV-A of the Social Security Act. Companies might have used their influence to protect child-care subsidies, had they been aware that some of their own employees would be affected by these cuts in service. The Child Care Tax Credit also helps working parents, but some feel that the credit should be based on more realistic child-care costs. Some employers have supported an expansion of the credit, currently limited to $2,400 for one child.

Many companies spend a considerable amount of time investigating their child-care options. They become intimately familiar with the child-care needs of their employees and the capacity of community services to meet them. With this knowledge, employers are testifying before Congress and participating on mayoral and gubernatorial task forces on child care. In this way, the views of the business community are considered in the redesign of the delivery system and attempts to improve the affordability and quality of child-care programs.

Part 3

Summary

Among the estimated 1,800 employers nationwide responding to child-care needs, the predominant response is the provision of some form of financial assistance. Among the financing options, flexible benefits is emerging as the most popular financing option.

A company's desire to provide meaningful financial assistance to the employee may result in considerable expense to the employer. At a time when companies want to control benefit costs, and also to improve their benefits packages to satisfy a new diversity in the work force, financial assistance for child care is most frequently embodied in a flexible benefit plan that includes a variety of benefit options. The vast majority of flexible plans offer bank accounts and salary reduction without total benefits revision. The need for child-care assistance has emerged during the planning of a flexible plan when employees have been asked to identify desired benefits.

The companies pursuing alternative approaches, such as vouchers and discounts, have a different orientation and commitment to solving child-care problems. Most of these companies conducted surveys of child-care needs among employees and examined the full range of child-care solutions before settling on financing options.

The vouchers represent the greatest financial commitment to child care of all the options, sometimes requiring a generous investment of corporate dollars. Vouchers are also the least popular option among companies in this survey. Discounts are also selected after an analysis of all child-care solutions, but they are less costly to the employer, may be less valuable (in dollar terms) to the employee, and more limited in their use because they may only be used at specific day-care centers.

The Future of Child Care Financing by Employers

The number of working parents with child-care needs is unlikely to decrease in the near future. Affordability may become the most pressing child-care problem as the cost of providing quality care increases and as employees seek care from credentialed programs to reduce worry about sexual abuse. As an alternative to starting their own child-care centers, some employers will concentrate on helping their employees pay for child-care already provided in the community. In this way, they can allow employees to choose their own arrangements and, as a result, serve a greater number of working parents with a variety of child-care needs. Among the range of child-care solutions, financial assistance—in its varied forms—may grow most rapidly.

Appendix A

Sample Dependent Care Assistance Plan[1]

This is a sample plan. Employers should consult their own tax attorneys or advisors with respect to adoption and implementation of any Dependent Care Assistance Program. If dependent care is to be offered as part of a flexible benefits program, then the requirements of Code section 125 must also be satisfied. The provisions of this sample 129 plan can be incorporated into a 125 plan which should be submitted to the Department of Labor.

ABC CORPORATION
DEPENDENT CARE ASSISTANCE PLAN*

1. *Purpose.* The company wishes to assist its employees in the care of their qualified dependents and therefore has adopted the ABC Corporation Dependent Care Assistance Plan (the "plan") set out herein for the exclusive benefit of those employees who are eligible to participate in the plan. The plan is intended to qualify as a dependent care assistance program under section 129 of the Internal Revenue Code of 1954, as amended and shall be construed to comply with Code section 129.

2. *Definitions.* The following terms are defined for purposes of the plan and are indicated by capitalized initial letters wherever they appear in the plan:

a. "Dependent" shall mean (i) any child of an employee who is under age 15 or who is physically or mentally incapable of caring for himself or herself and with respect to whom the employee is entitled to claim an exemption for federal income tax purposes or who is in the custody of the employee for at least six months during the calendar year; and (ii) a spouse of the employee who is physically or mentally incapable of caring for himself or herself.

b. "Employee" shall mean any person employed by the company any portion of whose income is subject to withholding of income tax and/or for whom social-security contributions are made by the company, as well as any other person qualifying as a common law employee of the company.

c. "Dependent Care Expenses" shall mean amounts paid for the care of a dependent in the employee's home or at a dependent care facility which meets all applicable requirements of state or local law or is exempt from such requirements under the state or local law in question and amounts paid for related household services, except that the following items shall not be considered dependent care expenses:

(i) Amounts paid to a person with respect to whom the employee or his or her spouse is entitled to claim an exemption for Federal income tax purposes;

(ii) Amounts paid to a child of the employee who is 18 years of age or younger; and

(iii) Amounts paid for or reimbursed under another plan of the company or to which the company contributed on behalf of the employee, under any Federal, state or local program of dependent care assistance, or by an employer of the spouse or by an educational institution where the spouse is an enrolled student.

3. *Effective Date.* The plan shall be effective on _____.

4. *Eligible Employees.* All employees of the company shall be eligible to participate in the plan.

5. *Reimbursement of Expenses for Dependent Care.*

a. Upon application of the employee, accompanied by a bill, receipt, cancelled check, or other written evidence of payment or of the obligation to pay dependent care expenses, the company will reimburse the employee for dependent care expenses incurred in order to enable the employee to be employed by the company, subject to the limits of paragraph b. The company reserves the right to verify all claimed expenses prior to reimbursement.

b. *Limitation on Benefits.* The maximum amount of dependent care expenses which will be reimbursed under this plan shall be the lowest of:

(i) $_____ per calendar year; or

(ii) If the employee is single or is married and earns less than his or her spouse in a calendar year, the compensation paid to the employee by the company as reflected on his or her Form W-2 for the year; or

[1] Prepared by Barbara B. Creed, Partner, Pillsbury, Madison and Sutro, San Francisco, CA and Deene Goodlaw Solomon, Counsel, Pillsbury, Madison and Sutro. Reprinted with permission from the Child Care Law Center, San Francisco, CA.

* Additional plan provisions will apply and other considerations will pertain if the plan is an "employee welfare benefit plan" as defined in section 3 (3) of the Employee Retirement Income Security Act of 1974, as amended.

(iii) If the employee is married and the earned income of his or her spouse is less than the compensation paid to the employee by the company in a calendar year, the earned income of the spouse. If the spouse is a student or is physically or mentally incapable of caring for himself or herself, the spouse will be deemed to have earned income (for each month that the spouse is a student or incapacitated) of $200 per month if the employee has one dependent for whom care is provided and of $400 per month if the employee has two or more dependents for whom care is provided.

The company may require that the employee and/or his or her spouse certify to the company the amount of such spouse's expected earned income for the calendar year in question and may require that the employee provide documentary evidence of the amount certified in the form of an employment contract, paycheck stub, medical records (if the spouse is incapacitated) or a school enrollment form (if the spouse is a student).

c. *Direct Payment in Lieu of Reimbursement.* The company may, in its discretion, pay any expenses for dependent-care directly to the dependent-care provider in lieu of reimbursing the employee in satisfaction of its obligations under the plan.

d. *Limitation of Benefits Paid to Prohibited Group.* No more than 25% of the benefits paid under the plan in any one calendar year shall be provided for the class of individuals (or their spouses or dependents) each of whom owns more than 5% of the stock of the company, determined in accordance with Code sections 1563(d) and (e) without regard to Code section 1563(e)(3)(C), on any one day of that calendar year. If the benefits payable under the plan to such class exceeds the limits of this paragraph, the benefits paid to each individual member of the class shall be reduced proportionately.

6. *Funding Method.* The benefits provided under the plan are funded entirely out of the general assets of the company.

7. *Notification of Terms of Plan.* A copy of the plan shall be given to all employees.

8. *Statement of Benefits.* On or before January 31 of each year, the company shall furnish each employee who received benefits under the plan a written statement showing the amounts paid or the expenses incurred by the employer in providing dependent-care assistance under the plan for the prior calendar year.

9. *Amendment or Termination.* The company may amend or terminate the plan at any time; provided, however, that any such amendment or termination shall not affect any right to benefits arising prior to such amendment or termination or shall cause benefits paid hereunder not to qualify as dependent-care assistance under Code section 129.

10. *Governing Law.* This plan and the rights of all persons under the plan shall be construed in accordance with and under applicable provisions of the Internal Revenue Code of 1954, as amended, ERISA and the laws of the State of California.

[Note: The following provisions should be added if the plan is an "employee benefit plan"]

11. *Fiduciary Responsibility and Plan Administration.*

a. *Plan Sponsor and Plan Administrator.* The "plan sponsor" and the "administrator" of the plan, within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA"), is the company.

b. *Named Fiduciary.* The company is the named fiduciary responsible for the operation and administration of the plan.

c. *Assignment of Duties.* The duties of the company hereunder shall be carried out in its name by its executive committee, officers and employees. The company may designate any person to carry out fiduciary responsibilities under the plan pursuant to a written instrument which specifies the fiduciary responsibilities assigned to each such person. Any person may serve in more than one fiduciary capacity with respect to the plan.

d. *Employment of Advisors.* The company or a fiduciary designated by the company, may employ one or more persons to render advice with regard to its fiduciary responsibilities under the plan.

12. *General Plan Information.*

a. *Employer Identification Number.* The Employer Identification Number assigned to the company by the IRS is: _____.

b. *Plan Number.* The Plan Number assigned to the plan by the company is: _____.

c. *Plan's Fiscal Year.* The date of the end of the year for purposes of maintaining the plan's fiscal records is: _____.

d. *Agent for Service of Legal Process.* The agent for service of process with respect to the plan is: _____

_____

TO RECORD THE ADOPTION OF THE PLAN, the company has caused this document to be executed by its duly authorized officer this _____ day of _____.

ABC CORPORATION

By _____

Its

Appendix B

Selecting a Tax Treatment Plan for Dependent Care: A Comparison Between Salary Reduction and the Dependent Care Credit*

by Sally F. Goldfarb, National Women's Law Center**

As more and more firms opt for flexible benefit plans, an increasing number of employees will face the choice between salary reduction and the dependent care credit as a means of gaining federal income tax savings for dependent care expenses. A taxpayer can use only one of these two tax treatment methods for any given dollar of dependent care expenses.

Although tax laws are continuously subject to change, it is useful to compare the current advantages of these two tax treatments for employees at various income levels.

The Rough Test

As a general rule, if an employee's marginal tax rate is lower than the percentage of dependent care costs that can be subtracted from the employee's tax liability by using the dependent care credit, then the employee will receive greater federal income tax savings by using the credit method.[1] (This comparison does not take into account Social Security tax savings available through salary reduction, because it could be misleading to do so without considering future Social Security benefits, which are subject to numerous variables beyond the scope of this article.) Of course, this rough test assumes that the employee's dependent care payments are equally eligible for the dependent care credit and for the employer's salary reduction plan. It also assumes that if dependent care benefits available under the salary reduction plan are not used, the employee will receive an equivalent amount of cash.

In order to apply this rough test, it is necessary to know the employee's adjusted gross income (which will determine what percentage of care expenses will be available as a credit) and the employee's taxable income (which will determine the marginal tax rate).[2]

To perform this comparison, the taxpayer should first locate the appropriate adjusted gross income on the Dependent Care Tax Credit chart (see page 8) to determine the percentage of care expenses that will be available through the credit. Then, the taxable income should be located on the applicable tax rate schedule in order to determine the marginal tax rate.[3]

[1] "Marginal tax rate" refers to the rate (that is, the percentage) of tax levied on the last dollar of an employee's taxable income.

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[2] *Adjusted gross income* is total income minus moving expenses, employee business expenses, IRA and Keogh deductions, penalties on early savings withdrawals, alimony paid, and the deduction for a married couple when both work. *Taxable income* is adjusted gross income minus itemized deductions, personal exemptions, and a partial deduction for charitable contributions if one does not itemize deductions.

[3] The annual tax rate schedules are provided by the Internal Revenue Service. Although the tax rate schedules are not actually used by all taxpayers for calculating tax liability (for instance, most taxpayers with taxable income under $50,000 must use the tax tables rather than the tax rate schedules), the tax rate schedules are nevertheless ideal for determining marginal tax rates because the percentage at which each dollar is taxed is stated explicitly. All tax rate figures in this article are for the 1984 tax year.

Case Example

For a more specific example of how to apply the rough test, consider the following case. Assume that a head of household has an adjusted gross income of $25,000. The taxable income, computed by subtracting various deductions and personal exemptions, is $20,000. The appropriate charts indicate that the taxpayer is entitled to a tax credit of 22% of dependent care expenses and that the marginal tax rate at this level of taxable income is 24%. Based on this rough test, the taxpayer would conclude that the salary reduction method is more beneficial than the tax credit.

Employers can provide helpful guidance to their employees by pinpointing the precise income levels at which the dependent care tax credit is generally preferable to salary reduction and vice versa. Such determinations are crucial to the effective use of flexible benefit plans.

In order to make these determinations, certain basic relationships must be kept in mind. It is important to remember that the percentage of the dependent care credit declines (or stays the same) as income increases. By contrast, marginal tax rates rise (or remain stable) with increasing income. Also, a personal exemption is available for taxpayers and their spouses. Thus, married couples gain at least $2,000 in personal exemptions, and single taxpayers and heads of households gain at least $1,000. These exemptions are, of course, subtracted from adjusted gross income when computing taxable income.

Using these basic relationships, it is possible to calculate, first, the adjusted gross income levels at and below which salary reduction for dependent care expenses is never preferable to the dependent care credit method. Consider a married couple filing jointly with an adjusted gross income of $26,000. With two personal exemptions, the adjusted gross income is reduced to a taxable income of *at most* $24,000. (The actual taxable income may be lower because of deductions or additional exemptions.)

At an adjusted gross income of $26,000, the dependent care credit is worth 22% of the care expenses incurred. This percentage will *increase* as the adjusted gross income decreases. At the same time, at a taxable income of $24,000, married couples with joint returns have a marginal tax rate of 22%, and that marginal tax rate will *decrease* as taxable income decreases. Therefore, at an adjusted gross income of $26,000 or less, married couples filing jointly will find the dependent care credit equally or more advantageous than a salary reduction scheme.

In the same fashion, heads of households will find the dependent care credit at least as advantageous as salary reduction at adjusted gross income levels of $22,000 or less. Similarly, single taxpayers with adjusted gross incomes of $19,200 or less will find the dependent care credit to be the more advantageous tax treatment method.

The adjusted gross income cutoff points identified above do *not* mark the points at which salary reduction necessarily becomes more advantageous than the dependent care credit. For instance, a married couple with an adjusted gross income of $26,001 may or may not have a marginal tax rate that is higher than their 21% dependent care credit, depending on their number of deductions and personal exemptions.

The above cutoff points have all been based on adjusted gross income. However, taxable income, not adjusted gross income, is the key to determining the points at which *salary reduction* becomes the more advantageous tax treatment.

The taxable income levels at and above which salary reduction is always initially preferable to the dependent care credit are as follows: for married couples filing jointly, $24,002 in taxable income; for single taxpayers, $18,202 in taxable income; and for heads of households, $21,002 in taxable income.

Refining the Test

Employers and employees should add two important refinements to the rough test previously described, in order to be sure that their conclusions are accurate for individual cases.

The first refinement involves the total amount of dependent care expenses incurred for the year in question. As an example, assume that for the tax year 1984, a single taxpayer with one child and two personal exemptions, but no deductions, has an adjusted gross income of $21,000. Deducting the two $1,000 personal exemptions, this taxpayer has a taxable income of $19,000. Using the rough test previously cited, the taxpayer would note that the 26% marginal tax rate for taxable income of $19,000 is higher than the 24% dependent care credit available for an adjusted gross income of $21,000. Thus, the taxpayer would conclude that using the employer's salary reduction plan for dependent care expenses was the better method. But there could be a hitch. Suppose that the taxpayer's dependent care expenses were more than $800 for the year. In that case, the taxpayer would be better off allocating the amount exceeding $800 to the dependent care credit. This is because once the taxpayer reduces his or her income by $800 through salary reduction, the taxable income level falls to $18,200 (at that level, a 23% marginal tax rate applies). The adjusted gross income becomes $20,200 (entitling the taxpayer to a 24% dependent care credit). At that point, the relative advantages of the two tax treatments have become reversed. (Such a "tipping point" does not occur, however, in instances in which the rough test shows that the dependent care credit is more advantageous than salary reduction and the credit is accordingly used first. This is because the credit is subtracted from tax liability and does not alter either the taxable income or the adjusted gross income.)

The second refinement to the rough test requires knowing the maximum permitted dollar amount of dependent care expenses under the salary reduction plan, and the maximum permitted dollar amount of expenses that may be claimed for the dependent care credit. These maximum permitted amounts may be established in several ways. Employers may set a fixed maximum for salary reduction generally, or for salary reduction, dependent care benefits specifically. The

statutory ceiling for expenses which may be counted toward the dependent care credit is $2,400 for one dependent and $4,800 for two or more dependents. Also, neither salary reduction for dependent care, nor expenses claimed for the dependent care credit, may exceed a taxpayer's or taxpayer's spouse's earnings, whichever is less.

If employees' dependent care expenses exceed the ceiling for their salary reduction plan or the credit—but not both—they should determine which of the two is more advantageous and then allocate their expenses to that option up to the maximum limit (unless they first reach a "tipping point," as discussed above). They should then allocate the remainder of their expenses to the other tax treatment. Of course, if employees' dependent care expenses equal or exceed the *sum* of the ceiling amount for the credit *and* the ceiling amount for their salary reduction plan, then they need not even determine which of the two is preferable; they should simply use each up to its applicable limit. Thus, for example, a taxpayer with $8,000 in dependent care costs who is eligible to claim $2,400 in expenses toward the dependent care credit and $5,000 in expenses through a salary reduction plan should use both of these methods fully—and will still have expenses "left over."

Necessary Information

As the above discussion indicates, employers or individual taxpayers wishing to use this refined test as effectively as possible need to have certain basic information available: yearly adjusted gross income, yearly taxable income, annual dependent care expenses, and the applicable ceilings on the dependent care credit and the salary reduction plan. They also must have access to the appropriate tax rate schedules and the dependent care tax credit chart. Ideally, all of this information should be obtained prior to the decision to elect dependent care benefits under a salary reduction plan for a given year. In fact, however, most taxpayers will have to make approximate projections of income and expenses and apply the refined test to these estimated figures.

One Method of Individual Tax Planning

While tax treatment decisions, are subject to continuous changes in the law, and must be fully evaluated by accredited professionals for each individual case, the author of this article believes that the following method of tax planning ensures optimal use of the dependent care credit and salary reduction for dependent care expenses.

This method involves eight principal steps. (All income figures are for 1984.)

1. For the year in question, first determine the amount of dependent care expenses that qualify for the dependent care tax credit and salary reduction. Then determine the ceiling on eligible expenses under the dependent care tax credit and under the salary reduction plan.
2. If dependent care expenses equal or exceed the sum of both ceilings, go no further. Use both tax treatments to the permitted maximum.
3. For the year in question, determine the adjusted gross income and taxable income.
4. If the adjusted gross income is less than or equal to $26,000 for married couples filing jointly, or $22,000 for heads of households, or $19,200 for single taxpayers, then proceed directly to step 7.
5. If taxable income is greater than or equal to $24,202 for married couples filing jointly, or $21,002 for heads of households, or $18,202 for single taxpayers, then proceed to step 8.
6. Determine the credit percentage by locating the adjusted gross income on the dependent care tax credit percentage chart. Find the marginal tax rate by locating the taxable income on the applicable tax rate schedules. Compare these two amounts. If the credit percentage is greater than or equal to the marginal tax rate, proceed to step 7. If the marginal tax rate is greater than the credit percentage rate, proceed to step 8.
7. Use the dependent care tax credit up to the applicable ceiling. Allocate remaining expenses to salary reduction. (It may be advisable to underestimate expenses for salary reduction in order to avoid the risk of forfeiting unused amounts at the end of the plan year.)
8. Determine whether there is a "tipping point". This is a level at which some portion of dependent care expenses, when subtracted from income through a salary reduction plan, reduces the taxpayer's taxable income to a point where the marginal tax rate is lower than the credit percentage available at the newly reduced adjusted gross income. If such a "tipping point" exists, allocate expenses to the salary reduction plan up to that point. Then allocate the remainder to the dependent care credit up to the applicable ceiling. If expenses still remain, allocate the remainder once again to the salary reduction plan. If there is not a "tipping point", allocate expenses to salary reduction up to the permitted ceiling and then allocate the remainder to the dependent care credit. (As noted in step 7 above, it may be advisable to underestimate expenses for salary reduction.)